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NOMINATIONS OF WAYNE D. ANGELL AND MANUEL HOMAN JOHNSON, JR.

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HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

NINETY-NINTH CONGRESS

SECOND SESSION

ON

THE NOMINATIONS OF

WAYNE D. ANGELL, TO BE A MEMBER OF THE BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM, FOR THE TERM OF 8 YEARS FROM JANUARY 31, 1986

AND

MANUEL HOMAN JOHNSON, JR., TO BE A MEMBER OF THE BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM, FOR THE TERM OF 14 YEARS FROM FEBRUARY 1, 1986

ORIGINAL

JANUARY 23, 1986

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NOMINATIONS OF WAYNE D. ANGELL AND MANUEL HOMAN JOHNSON, JR., TO BE MEMBERS OF THE BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

THURSDAY, JANUARY 23, 1986

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Heinz, D'Amato, Gorton, Mattingly, Hecht, Gramm, Proxmire, Cranston, Riegle, Sarbanes, Dodd, Dixon, and Sasser.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

This morning I want to welcome Dr. Wayne Angell of Kansas to the Banking Committee.

Dr. Angell has been nominated to the Board of Governors of the Federal Reserve System to fill an unexpired term that runs until January 31, 1994.

Dr. Angell is currently a professor of economics at Ottawa University in Kansas. His graduate work was done at the University of Kansas and he's been teaching economics since 1954. Dr. Angell's background, however, has not been limited to economic theory. He's been an active partner in a 3,300-acre farm since 1950. He has also served as president of a small bank in Missouri since 1972 and as chairman of a small bank in Kansas since 1975.

Given the serious problems besetting American agriculture and our agricultural banks, I believe Dr. Angell's extensive hands-on experience, not just theoretical, but actual hands-on experience in agriculture and in agricultural banks, will be of considerable value to the Federal Reserve Board.

The high regard which his fellow bankers have for Dr. Angell is evidenced by their having elected him three times to serve as a director of the Federal Reserve Bank of Kansas City.

Dr. Angell, we're happy to have you with us this morning and particularly happy that the majority leader is here and on time.

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STATEMENT OF ROBERT DOLE, U.S. SENATOR FROM THE STATE OF KANSAS

Senator DOLE. The reason he said that is we both left the same meeting and I didn't know he would beat me here but he did.

Let me just—I think the chairman has given a pretty good summary of Dr. Angell's qualifications. I want to stress the point you made about agriculture. I think it's been the wish of the chairman for some time and I think other members of this committee that we have agriculture represented on the Fed and we are in deep distress. We are particularly proud in Kansas because as far as we can find out you're the first Kansan who's ever been on the Fed and we think it's about time.

If we look whether it's the Midwest, the Southeast, wherever we look in rural America we have real problems. Wayne Angell is a real live farmer. He farms out in southwest Kansas and he's not someone who's an absentee landlord. He knows what it's all about and been doing that since 1950.

In addition, as the chairman has pointed out, he's been a member of the Fed in Kansas City. He's been active in banking. He's a professor of economics. I think he has outstanding credentials. Beyond that, I think it may be helpful to the committee to know that many times we introduce people that we've known but we really don't know. In this case, it's someone I really know. I mean, I have worked with Wayne Angell. We happen to be Republicans. He was one of my campaign chairmen in the Second Congressional District in Kansas. He was a candidate for the U.S. Senate defeated in a close primary by Nancy Kassebaum, so it's another indication of the respect he has in our State, not just among Republicans but Republicans and Democrats as well.

And I think it's very important and the fact that he's been out on the firing line, as we all have, trying to persuade people at the ballot box I think is another consideration, a positive consideration of this nominee.

So I'm just pleased to be here. I would ask that my statement be made a part of the record. I've been telling farm groups ever since the President submitted this nomination that I would expect and I would hope that Dr. Angell, if confirmed, would spend a great deal of time visiting with rural bankers, visiting with agribusiness types, farmers themselves, to see if there is some relief that we can bring from the top for a very troubled segment of our economy.

I know that this committee is very diligent in considering nominees, as you should be. I know that Dr. Angell is prepared to answer any questions that anyone on this committee will raise.

I would ask that my statement be made part of the record. I would also indicate that the nomination has the full support of our entire delegation, Republicans and Democrats. My colleague, Senator Kassebaum, is not in Washington today and could not be here. I would ask that her statement be made a part of the record. I thank you, Mr. Chairman.

The CHAIRMAN. Without objection, your statement will be, and I do have Senator Kassebaum's statement which we will include in the record, and we thank you very much for your willingness to be here this morning.

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[The complete prepared statements of Senators Dole and Kassebaum follow:]

STATEMENT OF SENATOR DOLE

Mr. Chairman: For me it is a great pleasure indeed to have the opportunity to present to this committee a very distinguished Kansan, one who will serve the country well. Wayne Angell brings outstanding credentials to the job of central banking and regulation of financial institutions, and I am sure this committee and the Senate will want to expedite his nomination to the Federal Reserve Board.

UNIQUE EXPERIENCE

Mr. Chairman, since 1979 Wayne has served as a director of the Federal Reserve Bank of Kansas City, so he is well-versed in the workings of the Federal Reserve System and understands the exceptional responsibilities which the Board of Governors must carry. In addition, Dr. Angell has extensive experience in banking with both banks and bank holding companies. Coupled with Wayne's business experience is his exceptional academic background, both at Ottawa University and in his own studies.

Those credentials make it clear that Wayne Angell will bring top-level skills to bear upon the problems faced by the Federal Reserve. Not only that, but Wayne has the unusual virtue of coupling a strong banking background with experience in agriculture. He has been active in farming since 1950—he understands the farm economy, its unique challenges and problems. No qualification could be more important for a position of high responsibility in determining the economic course of our Nation.

CRITICAL TIME

Mr. Chairman, this is certainly a time when we need individuals of the highest caliber to serve at the Federal Reserve. Both Wayne Angell and Assistant Secretary Manuel Johnson—another outstanding nominee before you today, though unfortunately not a Kansan—will have their work cut out for them at the Fed. The course of monetary policy will not be smooth, given the conflicting domestic and international pressures that are at work in this late stage of economic recovery. At the same time, weakness in some sectors of the financial services industry is contending with pressures for further relaxation of the barriers separating different types of financial institutions. So all told, your nominees this morning will have their work cut out for them.

Finally, let me note that we can do both of these gentlemen—and Chairman Volcker—a huge favor by acting to reduce the budget deficit, take some responsibility ourselves, and reduce the burden on the Federal Reserve to maintain the confidence of the financial community.

Again, I am proud to present Wayne Angell to this distinguished committee.

STATEMENT OF SENATOR NANCY KASSEBAUM

Mr. Chairman, it is with a great deal of pleasure that I offer my support today for the nomination of Wayne Angell for appointment to the Board of Governors of the Federal Reserve. I believe this committee will find Dr. Angell to be an outstanding individual who possesses all the requisite credentials for service on the Federal Reserve Board.

Wayne Angell has a breadth of experience that is hard to match. He has worked in nearly every field of the real world. As a professor, he has seen the enthusiasm of young people seeking to understand their world better. He has shown that he can both teach and learn. As a banker, he understands the demands of the financial system on a practical level. He has worked with small businesses, farmers, and individual consumers. As a farmer and rancher, he is uniquely aware of the challenges facing agriculture today and he fully understands the impact of macroeconomic decisions on family farms and rural America. Finally, as a member of the Kansas City Federal Reserve Bank's Board of Directors, he has the knowledge and broad perspective necessary to serve the entire country effectively.

I am convinced that the presence of a person with hands-on experience in banking, education, and agriculture will be of benefit to the Board and to the Nation. The Federal Reserve Board plays a crucial role in determining overall credit conditions and the future growth of our economy. Wayne Angell's nomination by the

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President and confirmation by the Senate will underscore our commitment to policy choices which will benefit everyone without sacrificing anyone.

Kansas is proud today to offer one of its most distinguished citizens as the next member of the Federal Reserve Board. I know that a review of Wayne Angell's record of private and public service will show that he is not only qualified and deserving of confirmation, but that he will be an invaluable member of the Board. I thank the committee for the opportunity to express my support for and confidence in Dr. Wayne Angell.

The CHAIRMAN. Senator Proxmire.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. Mr. Chairman, these nominations concern me deeply. I think the Federal Reserve Board has been the one powerful instrument of reason and stability in the Federal Government economic policies that have otherwise gone bonkers.

For the past 5 years we have suffered a series of appalling deficits, $109, $195, $175, $202 billion, and this year we are on our way to another $200 billion deficit even with Gramm-Rudman-Hollings cutting the deficit by $11.7 billion.

In most of the past 6 years the Federal Reserve has followed a monetary policy which was vehemently criticized by many. But despite our grossly irresponsible and inflationary fiscal policy the Fed broke the back of the worst inflation in the Nation's history.

Meanwhile, the Chairman of the Fed, Paul Volcker, has been properly and rightly reminding the Nation and the Congress that the present fiscal policy of huge back-to-back deficits through an economic recovery period is an unmitigated disaster.

Today we have before us for confirmation two able and respected appointees to the Federal Reserve Board. One of them might very possibly succeed Chairman Volcker as chairman in August 1987, less than 2 years from now.

Both of these impressive, articulate, highly intelligent nominees seem to see little if any danger in the deficit. In fact, both appear to favor a monetary policy that will accommodate the deficit. They want a monetary policy that in my judgment would be aimed temporarily in the short run of holding down interest rates—I want to emphasize in the short run.

In the long run, I firmly believe these policies will cause superinflation and maybe worse. Even if neither succeeds to the chairmanship of the Fed, these nominees provide a basis along with other appointees of this administration for a radically new Federal Reserve policy. The policy will differ not only from that pursued by Chairman Volcker, but also Chairmen Burns and William McChesney Martin.

In the 28 years I have been in the Senate and on this committee, that policy has been bipartisan and consistent. It's often been severely criticized, but it's served the country well and now it's about to change.

The last thing we need on the agency that determines the Nation's supply of credit, in my judgment, are members who believe that the Federal Reserve Board should accommodate the colossal deficits by supplying the credit the deficits demand.

Dr. Johnson has said that he believes the Federal deficits have little to do with interest rate fluctuations. Dr. Angell has apparently written or said little about the economic consequences of the

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deficits, but he appears to believe that monetary policy can function with little or no reference to the size of Federal deficits.

He writes in the letter he provided to Senator Dole and which he graciously provided to me:

> When U.S. monetary policy moves from ease to firmness the international demand for dollars can be expected to soar. My primary disagreement with the Board of Governors in my 6 years as a class A Director at Kansas City has been in allowing the dollar to appreciate in excess of 70 percent against most international currencies.

So Dr. Angell does not blame the deficits for the rise in the dollar value and the consequent deterioration of our trade balance. Instead, he blames what this Senator has construed as the anti-inflation policy of the Fed moving from ease to firmness to break the back of inflation.

So I admire the quality of both these nominees and their remarkable ability to make their views appealing, but I am deeply troubled by the consequences of these nominations for our economy. Big inflation, here we come.

The CHAIRMAN. Senator Gramm.

OPENING STATEMENT OF SENATOR GRAMM

Senator GRAMM. Mr. Chairman, let me say that I appreciate having had the opportunity to visit with both Dr. Angell and Dr. Johnson. In my year in the Senate, I don't know of two appointees that I have seen who have been better qualified.

In listening to our distinguished colleague from Wisconsin, I rejoice in the fact that the Fed is no longer in the battle against the ills of deficits alone. We in the Congress have committed ourselves to a 5-year program that will be tough on politicians but will be good on the people who do the work, pay the taxes, and pull the wagon. It will require, however, recognition at the Federal Reserve that as we reduce the degree of fiscal stimulus by reducing the deficit, that it's important that there be a transition so that the private sector can expand demand and fill the gap left by the reducing deficits which I hope we produce under the Balanced Budget Emergency Deficit Control Act.

I think during that period we do need an expansive monetary policy but a steady policy and I believe we can accommodate the transition to expanding private demand. Quite frankly I rejoice at the fact that we have two excellent nominees before the committee today who can provide the leadership that we're going to need.

I guess there are those who think we have too many economists in Government today. I think quite frankly we don't have enough. But I especially am pleased about the fact that Dr. Angell is not just an economist and a distinguished academician but that he has practical experience as well. I guess now you have to own a bank to be in farming in Kansas, but with your broad experience, I think the practical knowledge you bring combined with an understanding of the economy, I think is going to be a real contribution to the Federal Reserve. This will be at a time when we're going to need strong leadership and I'm very proud of these two appointments by the President and I vigorously support them both.

The CHAIRMAN. Thank you, Senator.

Senator D'Amato.

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OPENING REMARKS OF SENATOR D'AMATO

Senator D'AMATO. Thank you, Mr. Chairman.

Mr. Chairman, I have several questions for the record and an opening statement with respect to both nominees. I'm not going to comment about whether we need more or less economists in Government. That's a matter for debate, but I am pleased that the two nominees have backgrounds and demonstrated sensitivity to the issues that will serve the country well. This is something that is necessary at the Federal Reserve because I think there have been times when the Federal Reserve has been less than responsive to some deep economic problems facing this country because, at times, I think Mr. Volcker inflicted a little too much pain on the country. We forget those days—and there was a Congress with almost a united voice that said, "My God, loosen up on the money supply. Bring down that discount rate. We're putting people out of business unnecessarily."

I think it's important to have some people who may look at this with a broader perspective. I would ask that the balance of my remarks, Mr. Chairman, be placed in the record as if read in their entirety.

The CHAIRMAN. Without objection.

[The complete prepared statement follows:]

STATEMENT OF SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. I want to welcome Dr. Johnson to the committee this morning to address certain issues that will confront him as a member of the Board of Governors of the Federal Reserve. Due to the role that the Fed plays in shaping monetary policy, which in turn affects the inflation rate and real economic growth, I believe that a Governor of the Federal Reserve System is one of the most important nonelected officials in the Federal system. The influence exerted by the Fed on economic policy and our financial system requires that it jealously guard its status as an independent agency of the Federal Government.

During his tenure, Dr. Johnson will be required to address issues that range from the regulation of junk bonds to deposit insurance reform, in addition to making decisions affecting monetary policy. Due to the nature of these issues and their impact on the economy, the decisions of the Board must be guided by public policy considerations rather than political expedience. This does not mean that the positions of my colleagues or the administration should be ignored; rather, they should be accorded proper deference. Although I share the opinion of Dr. Johnson regarding the general role of the Fed, which is to support policies fighting inflation and promoting stable economic growth, and certain specific reforms of existing financial regulations, I question his commitment to the deregulation of the financial services industry.

Despite this difference, Dr. Johnson's academic and professional accomplishments recommend him for the position to which he has been nominated. I look forward to working with him in the future.

The CHAIRMAN. Senator Cranston.

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OPENING REMARKS OF SENATOR CRANSTON

Senator CRANSTON. I welcome the nominees and I welcome the distinguished introducer of the nominee at the table.

I have one comment. I think that the President should have more ability to have the Fed accommodate the administration's economic policies more directly. We then will have a firmer picture of who is responsible for what is happening to the economy. One of my concerns about the Fed has been that it is somewhat removed from the political process.

So while reserving final judgment, I am presently and strongly inclined to support these nominations primarily because both the people are obviously qualified in this field but, more importantly, they will reflect the President's views on the Fed and I think that's appropriate.

The CHAIRMAN. Senator Gorton.

OPENING REMARKS OF SENATOR GORTON

Senator GORTON. Mr. Chairman, I suppose there are probably some members on the committee who wish that our own professor of economics were out there rather than up here.

Senator GRAMM. I'm the minority.

Senator GORTON. But we're happy to have him up here and I think that his efforts over the last 6 months may well have made the task of these two nominees, once they are confirmed, easier and more likely to be productive than would otherwise be the case.

I feel that these are the two more important nominations which we have had before this committee during the time that I have been a member of it with the exception of the renomination of the Chairman of the Federal Reserve himself. When the Senate and this committee are dealing with nominations for extended periods of time which will go far beyond the term of the President who has nominated them, our responsibilities are particularly significant. It does mean that their views on economic issues are legitimate subjects for inquiry because of the importance of the Board to which they have been nominated.

I met with both nominees yesterday. I was both impressed and encouraged by what they said. I think we often say that hindsight is 20-20. I'm not sure that even hindsight is 20-20 when we deal with the subject matter with which the Federal Reserve Board deals. Clearly, foresight is not, and the degree of wisdom, a willingness to listen, very, very sound academic and business backgrounds are all major qualifications for these positions. Both nominees, it seems to me, share those qualities, but I will be most interested in hearing the details of their views on both the immediate past and the immediate future of the Federal Reserve Board as we go through these nomination hearings.

The CHAIRMAN. Senator Dixon.

OPENING REMARKS OF SENATOR DIXON

Senator DIXON. Mr. Chairman, I ask that I be permitted to place some questions for Dr. Angell in the record. I welcome him to this hearing this morning and simply wanted to comment that I examined his statement and I see he's been a director of a Federal Re-

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serve Bank in Kansas City. I also see he's been a member of the Kansas Legislature and was once a precinct committeeman and I'm glad to see that he's well qualified for the job that the distinguished majority leader has recommended him for to this committee and I'm delighted to have him as a guest.

Senator DOLE. And a farmer, too.

Senator DIXON. And a farmer as well. He might be overqualified.

The CHAIRMAN. Senator Mattingly.

OPENING REMARKS OF SENATOR MATTINGLY

Senator MATTINGLY. Thank you, Mr. Chairman. I have a statement for the record and will have some questions for Drs. Angell and Johnson.

I would like to say that obviously you are fully qualified to serve. I'm, however, a little bit concerned that your birthplace is Liberal, KS. Some of us would have felt a little bit more secure if that had been Conservative, KS, but I'm certain that your associate there, Senator Dole, who's going to speak for you, can take care of the conservative side. It is good to have another economist in the Government. It's just unfortunate that he's not elected, Senator Gorton, but nobody is taking shots at anybody. We love economists. I would like to say welcome really and I know you will do a great job.

I would like you to address sometime during your remarks the possibly of the Federal Open Market Committee releasing the minutes of its meeting more rapidly than they currently do. I think a lot of people are concerned over that delay. As you probably know, I have introduced legislation, as have others, to make the minutes more available rather than holding them for 1 or 2 months.

Thank you, Mr. Chairman.

PREPARED STATEMENT OF SENATOR MATTINGLY

Senator MATTINGLY. Mr. Chairman, I, too would like to welcome Dr. Johnson and Dr. Angell to the Senate Banking Committee. I think the President has chosen two very capable and qualified individuals to serve on the Federal Reserve Board. While I will have questions for the record, I would like to make a point or two.

Last Congress, I introduced the Federal Reserve Reform Act. Among other things, it required the minutes of the Federal Open Market Committee to be released in a more timely fashion. I personally can think of no justification for withholding from the public that information for 2 months. Senator Garn has expressed a similar concern. Such action, or inaction I should say, only leads to speculation in the marketplace. I will soon reintroduce that proposal and intend to hold hearings on the issue in the Economic Policy Subcommittee which I chair. I hope both nominees will take a good look at this legislative suggestion.

Last, I would like to remind the nominees, although I am preaching to the choir, that while the Government may have an answer for every problem, in most instances, the solution can be more effectively and efficiently addressed by the marketplace. A recent example of unnecessary Government intervention is the Fed decision to limit the use of junk bonds. As Fed Governor Seger said, the de-

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cision will lead to "heavy-handed bureaucracy." I hope the Fed will reconsider the issue. In my opinion, more government is not always good government.

Again, I congratulate both nominees and look forward to their speedy confirmation.

The CHAIRMAN. Senator Cranston.

Senator CRANSTON. Mr. Chairman, after all these comments about economists, I want to say one more thing. Another nominee of the President, Ted Cummings, was before the Foreign Relations Committee sometime ago to be Ambassador to Austria. In the course of his testimony he was asked why is Austria's economy working so very well in a Europe where things were not going too well at that time? He said it's because of their export policy. A member of the committee said, "Their export policy? What is that?" He said, "They exported all their economists to the United States." [Laughter.]

The CHAIRMAN. Now if we could just include attorneys with the economists, we would be all right.

Dr. Angell, could I have you stand and be sworn, please, before you testify.

[Whereupon, the witness was duly sworn.]

The CHAIRMAN. Dr. Angell, we are pleased to have you with us today. Before I have you begin I would like to comment in general on your qualifications. Over a number of years many of us on this committee have felt very strongly that the Federal Reserve Board has not had the broad geographic representation, which is called for in the Federal Reserve Act.

Over a period of years we have found many ways to circumvent the geographic requirements—if somebody attended a California college he was from California; if they were born in Illinois that was fine even though they left at the age of 1; and we were getting a concentration of those who essentially were from the Washington economic establishment.

There also have been many bills that require representatives from small business, from labor, and from other economic sectors.

Over the last 5 or 6 years, both Senator Proxmire and I, have insisted that this administration and the Carter administration before it comply with the intent of the law regarding geographical representation.

You, Dr. Angell, certainly fit that requirement, coming from Kansas. Senator Dole pointed out that you will be the first Kansan on the Board. Even more importantly I think is your background. You are an economist, but not just an economist. You also have had wide experience in agriculture, which is particularly important at this time, and in small business. So I guess we could call you a three-fer—agriculture, small business, and economics.

I felt it was important to give you that little bit of background and once again state that in the future I'm sure the committee will insist that we have a broader background distribution on the Fed—both in experience as well as in geography—to fit the terms of the law.

If you would like to proceed with your statement at this time we would be happy to hear from you.

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STATEMENT OF NOMINEE DR. WAYNE D. ANGELL

Dr. ANGELL. Thank you, Senator Garn. I am most honored to be a nominee of President Ronald Reagan and to have the wholehearted support of the majority leader of the U.S. Senate, Robert S. Dole.

Last July, Senator Dole asked me to write out some monetary policy ideas which would be of particular significance for agriculture. Since that time Senator Dole has circulated the paper to members of this committee and to the press. I have saved my comments on these ideas expressed in that paper until this committee held its hearing regarding my nomination.

INVOLVEMENT IN FARMING

I am not going to go into as much detail concerning my farm background as I might have because of Senator Garn and Senator Dole's introduction of me as a farmer, but I assure you that my involvement in farming has been a lifetime involvement. I was a young person during World War II; I reached age 14 in 1944. During the war, I suppose farm families needed farm help more extensively than at other times, so I was promoted to combine driver at age 14. Of course, after the harvest I was back on the tractor doing a one-way disking operation.

Since I attended college and went on for my doctorate at the University of Kansas, I returned to the farm every summer and was a resident in Plains, KS, where the farm is located, since 1950, so farming has been an extensive part of my life. My wife has been the reluctant mover at times, and has disrupted her life to move to western Kansas, but we've done that as a family and our four children have grown up there and been involved in farming.

So, I have all the sense of the spirit of farming, and I have that sense from my heart in terms of the pain and the agony that have been associated with farmers during this period.

I want to make it clear that I do not believe that the answer to the farmers' problem is reinflation. Senator Proxmire, during my entire time at the Federal Reserve Bank of Kansas City I have established a reputation for being an inflation-fighter. The farm problem has its origins in the period of inflation, in the speculative activity in regard to buying farm equipment spurred on by tax laws that encouraged overbuying; the impact of inflation on commodity prices, leading directly to a rapid increase in farm land values, is the real root problem that's there.

Now it was impossible for this generation of older farmers to pass on the mantle of farming to a new generation of farmers with those ridiculously high land values, so the ones who are to blame primarily for our farm difficulty are those who put policies in place that led to inflation.

I pledge to this committee and I pledge to the American people that in my time on the Federal Reserve Board I will be ever-watchful for any reemergence of inflation. I consider it the primary responsibility of monetary authorities to preserve the value of the dollar, and that is my pledge.

I hope we will never see commodity prices as high as we saw them during the 1970's and early 1980's. We have indicated and

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demonstrated our commitment to reducing inflation; and I say we because as a director of a Federal Reserve Bank in Kansas City I have voted in favor of more discount rate increases than any directors prior to my time. I did that because I recognized that it was essential that the country's and the world's monetary leadership reduce inflation and there is no way that I will ever advocate any policy that will return our Nation to a course of inflation, which would in a sense cause us to fight this fight all over again. There's been too much pain and too much agony on the farm for us to slacken our stand against inflation again, and I give you my pledge in that regard.

FISCAL CONSERVATIVE

Now, Senator Proxmire, I would indicate to you that I'm a fiscal conservative. There's been no time in my entire adult life that I have ever advocated deficits as a way of alleviating difficulties. During my young teaching days as an economist I never accepted the Keynesian notion that Government budget deficits should be a part of policy. I believe that Government spending always places a burden upon the private sector of our economy, and it has an impact upon economic growth.

I do not excuse Government deficits and their role in causing the dollar to be high. The dollar in a sense moved high for several reasons and I think those are, as Senator Proxmire pointed out, that Government deficits do, of course, contribute to an upward movement in U.S. interest rates, although not as much I believe our tax system does with loopholes that in a sense impose different burdens upon different people. I believe that lowering tax rates would be more effective than even decreasing deficits, but reducing deficits is very important, and I commend this Senate and the Congress for taking the steps that need to be taken to bring the deficits down.

I have felt that the Federal Reserve, if it's to be faulted, should only be faulted for not understanding how effective its policy would be in bringing the inflation rate down. It seemed to me very clear that the policies adopted in 1979, were going to be successful. I didn't vote for those discount rate increases because I thought that inflation would still soar ahead, as many did. It seemed to me very clear that the Federal Reserve laid out a new standard on October 6, 1979, and that was to make the dollar more scarce than any commodity in the world.

Now once we did that, then the dollar necessarily began to rise, from its low level of about 78 indexed to 1970, and by December 1982 the dollar had risen from 78 to a level of about 128 on that index. Senator Proxmire, I asked the Chairman of the Federal Reserve at that time, having the opportunity to sit at his table during a directors' meeting, "How important do you believe exchange rates are in establishing monetary policy?" He leaned back in his chair and he said, "I believe that exchange rates are more important than we made them be." But after that time, the dollar rose from 128 to 161. I cannot imagine how anyone thought our economy could operate with such a high level for the dollar.

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So what I called for on July 5 in my memo that you have, was for the Federal Reserve to be willing to use some of its open market operations to engage in exchange rate intervention so as to readjust the world's thinking in regard to inflation.

But my policy overall has been one of support; I am a Fed loyalist in the sense of getting inflation down, and I think that's the most important thing we can do.

In closing, I want to point out to all of you that our banking system—the banking system including savings and loans, commercial banks, credit unions—has in it assets that are not of the highest quality. We have more risk assets there than we would like to have. I believe we are in a dangerous period in American history. If there's a second major responsibility of the Federal Reserve it is to ensure that the banking system is sound. Whenever the banks go down, whenever a bank closes in a Kansas town, the life of that community is affected; communities disappear when the banks disappear. It seems to me we have to give all the attention that we can give to focusing on the problem before us, which is maintaining a zero rate of inflation, maintaining a stable commodity price level, and preserving a sound banking system. I pledge myself to do those things, and I welcome the support and comments of each of the members here. I'm open for any questions that you might have.

DECISION ON NONBANK BANKS

The CHAIRMAN. Thank you very much, Dr. Angell. You jogged my memory on something when you referred to banks' safety and soundness. Before I ask you some questions I would like to comment on the Supreme Court decision that was made concerning nonbank banks.

I have listened to the news media for 2 days now about an approaching vast expansion of nonbank banks. I would suggest that the news media might read the decision before they report on it. When I came to work yesterday I thought maybe we needed to do something very quickly, but reading the decision I find that it is a very narrow decision. On an 8-to-0 vote, that I totally agreed with, the Supreme Court said the Federal Reserve does not have the right to regulate those nonbank banks and with the definition of a bank currently in law. The Federal Reserve doesn't have the right to change that definition. Only Congress can change the definition of a bank.

Importantly, there is still an appellate court decision which has created a moratorium, in effect, that prohibits the Comptroller of the Currency from granting any final charters to nonbank banks. So I would hope that the news media would report differently than they have been on how narrow this decision is. It is a correct decision, but still the Comptroller of the Currency is prohibited by a court decision from granting final charters. They have a very narrow area under State jurisdiction where some State-chartered institutions could expand the number of nonbank banks but there is not going to be in the near future any great proliferation of nonbank banks.

Senator PROXMIRE. Would the chairman yield on that?

The CHAIRMAN. I'd be happy to.

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Senator PROXMIRE. As long as the chairman has spoken out on that, as usual, he's expressed the kind of responsibility the committee should have and I assume that he is not saying that we don't need legislation. As I understand it, he's saying we do need legislation and I think we need it quite urgently because while no nonbank banks can be chartered, the fact is that we have nonbank banks now and in the judgment of many, many people the competition is grossly unfair. We have an unbalanced kind of situation that calls out for action by the Congress. In fact, the Supreme Court, as I understand it, encourages action by the Congress and implied that in their judgment it was desirable. So I would hope we get it.

The CHAIRMAN. The Senator is absolutely correct. That's why I say the Supreme Court decision is correct in this area. It does require legislative action for us to change the definition of bank. As a matter of fact, the Senator was a cosponsor of my bill that passed the Senate 89 to 5 in September 1984 that totally and completely closed the nonbank bank loophole. It is not the fault of the Senate that this has not been taken care of legislatively. We spoke rather overwhelmingly with that kind of a vote. The House of Representatives was not willing to go to conference then and has not been willing to act on it since, so your comments are appropriate and absolutely accurate. We still need to take action on this. I wish we had done so in September 1984.

Dr. Angell, it is my understanding that if confirmed you will divest all of your bank stock, sell your interest in a financial consulting partnership, and cease all of your financial consulting relationships. Is that correct?

Dr. ANGELL. That is correct, Senator Garn.

The CHAIRMAN. You will also sell the savings and loan stock in you personal 401-K pension plan as soon as the savings and loans permits the stock to be traded?

Dr. ANGELL. That's correct, and I had word from them last night that they will permit me to do that as soon as I get them a letter requesting that be done.

The CHAIRMAN. It is my further understanding that you have agreed to take all necessary steps to avoid even the appearance of a conflict of interest, is that correct?

Dr. ANGELL. That is correct.

The CHAIRMAN. And do you agree to appear before this committee and any other duly constituted committee of the Congress when requested to do so?

Dr. ANGELL. I would welcome the opportunity for any communication between us; between the Senate, the House, and the Federal Reserve.

The CHAIRMAN. I'll guarantee you will have plenty of opportunity for that.

Proposals are regularly made to reduce or eliminate the independence of the Federal Reserve. I think I have seen all of them over the last 10 or 11 years—proposals that we make the Chairman of the Fed's term concurrent with that of the President, that we have Treasury Secretary be a member of the Federal Reserve Board, that we have Members of Congress put on the Federal Reserve Board, and all sorts of other variations.

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I personally feel very strongly that one of the strengths of the Federal Reserve has been its independence. I would hate to think what would have happened over the last 10 or 12 years had Congress had the ability to control the money supply targets. We would have had an inflation and demands to go far beyond what the Fed has done. Whether I agree or disagree with particular Presidents, I also feel strongly that a President should not be able to dictate to a Federal Reserve Board. The Board should have an objective viewpoint separate from the legislative and executive branches.

INDEPENDENCE OF THE FED BOARD

How do you feel about the independence of the Federal Reserve Board? Are you here to just carry out the policies of the President who nominated you? Do you feel you're supposed to do what this committee tells you to do? What are your attitudes on the independence of the Federal Reserve Board?

Dr. ANGELL. Senator Garn, I'm among those who strongly believe that the Federal Reserve should remain independent. I believe the Congress was very wise in its decision in the Federal Reserve Act of 1913 to look toward the long-term independence for the Fed.

The problems of inflation quite often have a time lag attached to them. We can institute policies in one period and then reap the grain that we sowed in a later period. Quite often, the fact that Members of Congress and the President do have the political process to deal with and do stand for election might tend to make the executive and congressional branches take a more short-run view.

My view that the Federal Reserve's major responsibility is price level stability implies that this arrangement of having the Fed be independent is essential for that guarantee for the future.

With regard to the second part of your question, dealing with my independence from the President or anyone else, I would suggest to you that I have widespread support in regard to my nomination and that the paper that you have before you I wrote on July 5, 1985, before I had spoken to any members of the executive branch of Government; and I continue to hold those views. In fact, one of the members of the administration asked me some questions about that and I finally said, "I put down there those ideas against the recommendation of many of my colleagues who suggested that all I was doing was giving ammunition to my critics." I suggested to him that if I had to muzzle my ideas in regard to economic and monetary policy in order to get the President's nomination, I did not choose to serve on the Board. And I was very pleased that the member of the administration seemed to think that was a very good answer.

So I feel very confident that everyone supports this independence. In fact, the only question that was ever asked in regard to any litmus test was can you be independent? And I think that anyone who knows Wayne Angell certainly knows that I not only can be independent, but that I am.

The CHAIRMAN. Well, I'm pleased to hear that. In the paper you refer to, and I quote: "Discretionary monetary policy has a great potential to do extensive harm and provide significant disruption to

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what might otherwise be a healthy growing economy." In the same paper you support a monetary policy "focused on stabilizing the commodity price level."

Could you elaborate on those views for me? You've made yourself very clear here today in the statements you've made so far and yet there appears to be a little confusion in the minds of some regarding this paper as compared with your very clearly stated views today about the relationship of the Federal deficits, monetary policy and this statement about discretionary monetary policy which has a great potential to do extensive harm.

VIEWS ON COMMODITY PRICE LEVELS

Dr. ANGELL. Yes. I'm glad to have an opportunity to deal with the question of my views on stable price levels and the role of commodity prices.

I never said in the paper and I never intended it to be interpreted that I was asking for commodity prices to be an intermediate target. I was speaking for and advocated that the ultimate goal of monetary policy should be stable prices, a stable price level, in which commodities move up and down in price based upon their relative scarcities, but not due to an overabundancy or stringency of money as a driving force in those prices.

I do not wish to substitute for an M1 target a commodity price target, but I do believe that commodity prices, for which daily auctions are held, can provide a very important information variable for monetary policy. Whenever we look at commodity prices and see, as we have, that commodity prices have tended down over such a long period of time, we note that the world better be prepared to understand the Federal Reserve knows how to bring commodity prices down.

Anyone who wishes to bet on owning gold or silver or precious metals, or anything other than dollars should know it's our job to make those commodity prices stable and thus to ensure that they've made a poor bet.

Now I do not believe that it's appropriate in regard to these commodity prices to simply focus on an inflation rate target and then to make cumulative errors. Because if we focus on a target and we end up getting a 3-percent inflation, by goodness, the price level doubles every 24 years. In that scenario, long-bond buyers are going to look at an erosion of the purchasing power of those bonds and interest rates on those long bonds will be much higher.

I advocate a policy of not only having a zero rate of inflation, but also a policy that will correct for past mistakes and bring the price level back, so that people can have a guaranty that the dollar will have a purchasing power 10 years from now very similar to its purchasing power today.

Another reason that I focus on commodities is because of my experience in the agricultural sector. It seems to me that the service sector of our economy, which is growing very rapidly, is not very immediately responsive to monetary policy; that is, we can have the very best monetary policy in the world yet we sometimes will have a time lag where the service sector continues to have built-in price increases. I do not believe that those service sector price in-

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creases are subject to immediate discipline by monetary policy, and to try to bring the service sector inflation rate down in a very short period of time would be a policy that would totally disrupt the entire farming community worse than we have seen, disrupt the entire oil-producing segment of our economy, and of other nations.

I believe it's appropriate to focus upon a commodity price stability so that then the consumers will learn, as they have learned, that commodities don't rise in price as fast as services, and we will begin to see consumers shift their purchases from the service sector to the commodity sector until people in the service sector begin to realize that they can't pass the price increases along.

So I believe that if we maintain stable commodity prices we take away all of the speculative activity in our society, and we take away the misdirection of economic activity from speculation and direct it back to production. I want it to be in our market price system that individuals make a profit because they produce something, not because they speculated with some accuracy.

The CHAIRMAN. Senator Proxmire.

NO. 1 PRIORITY—STOP INFLATION

Senator PROXMIRE. As I understand it, it's your intention to make the stopping of inflation your No. 1 priority in the Federal Reserve Board. That's excellent. I think almost everybody would subscribe to that and I think it's right and you express it with great sincerity and emphasis.

The question is not your sincerity or your convictions. The question is the policies that you advocate and whether they would actually stop inflation.

In your paper setting forth your views on monetary policy you said:

> The Federal Reserve Board should consider making it a first priority to select a market basket of commodities that will not be permitted to increase or decrease more than 10 percent from a base price level. Errors should not be allowed to become cumulative.

Now as I understand your proposal, inflation would be stopped dead in its tracks once the price index rose 10 percent. In other words, the Fed would bring the ongoing rate of inflation down to zero.

How do you think the Federal Reserve Board could accomplish such a result, given the tools it now has, and wouldn't it have to engineer a rather deep recession to squeeze all inflation out of whatever price index was selected?

Dr. ANGELL. Senator Proxmire, as you know and understand—and behind your question—is the indication that there are certain periods of time, such as in the early 1970's when we had in a development of a cartel in oil prices; we had at the same time, certain shortages in regard to commodities due to the new purchase of grains by the Soviet Union and other countries.

My contention would be that it would have been far better during that period of time in which the M1 growth path was not so alarming compared to present numbers—that is, during that period of time we're looking at maybe 6 and 7 percent M1 growth paths—in hindsight, to have been much more tight with monetary policy,

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because if we had been, the price of land in Iowa, Nebraska, and Kansas, Oklahoma, and Ohio would not have risen as high as it did. We would have stopped inflation then.

Senator PROXMIRE. Let me just interrupt to ask you, Dr. Angell, if we had been much tighter, wouldn't interest rates have gone even higher? As you know toward the end of the 1970's if this had been able to work its course interest rates were at record highs. How high would they have to go, 25 percent, 30 percent?

Dr. ANGELL. Senator Proxmire, it would be my estimation that if a tighter monetary policy had been in place in 1972, 1973, 1974, that we would not have had interest rates as high as we had them in 1980 and 1981 and 1982; the failure was in not stopping the commodity inflation once it began.

I feel very strongly on this point, Senator Proxmire, but I would also want you to recognize that as a member of the Board of Governors, if you confirm me and I achieve that position, then I would also, of course, expect to listen to other people's views. I would not expect, by myself, to be able to adopt such a shift in policy without convincing other members of the Board, but I would expect that collegial process to go on, and I would make it a personal responsibility to represent the agricultural community and its needs, and not to misdirect economic activity toward the land speculation that occurred between 1973 and 1982.

Senator PROXMIRE. Now let me ask you, what do you recommend be included in your market basket and how would it differ from current price indices such as the Consumer Price Index, the Producer Price Index, the GNP deflator, and so forth? How would your market basket differ?

Dr. ANGELL. Senator Proxmire, the Federal Reserve no longer publishes the commodity index, and so at this point in time we have to choose between a lot of indices that are not really very good. That is, there aren't any indices that would meet my standards of being——

Senator PROXMIRE. You say they're not very good. They're good for some purpose. They're not good for all purposes.

Dr. ANGELL. That's right.

Senator PROXMIRE. That is likely to be true. What you're suggesting is simply an additional index which would not necessarily be better for all purposes or do you think it would be?

NEW INDEX ON A TRADE-WEIGHTED BASIS

Dr. ANGELL. I think it would be better for the purpose you and I are discussing. It would be better if we put it on a trade-weighted basis; that is, I believe that the United States and the Federal Reserve are not only responsible for domestic inflation, but I believe, since the dollar is the primary means of payment in the world, that we are responsible for the world inflation.

Senator PROXMIRE. What do you think should be included in market basket?

Dr. ANGELL. I think items ought to be included on a trade-weighted basis.

Senator PROXMIRE. What should be included?

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Dr. ANGELL. Items ought to be included on a trade-weighted basis. We ought to take an international trade-weighted basis.

Senator PROXMIRE. Would you include oil?

Dr. ANGELL. Yes.

Senator PROXMIRE. Would you include wheat? What would you include?

Dr. ANGELL. I want to put them all in there on a trade-weighted basis. I want to take all auction market commodities and say what proportion of international trade takes place in these commodities. We could argue about whether it should be an international trade-weighting or a national trade-weighting, but I would tend to opt somewhat toward the international trade-weighting. I would like to include all commodities on a trade-weighted basis, so that we could have some auction results that might give us some early warning signs.

Senator PROXMIRE. You're talking about crude commodities or are you talking about finished goods?

Dr. ANGELL. I'm talking primarily about those traded in auctions, and those are primarily agriculturally based or crude products, not manufactured products.

Senator PROXMIRE. All right. If the Federal Reserve Board should try to stabilize basic commodity prices, one measure is the crude material index of the Producer Price Index. During the first three quarters of 1985, this index fell by 11 percent. Under your proposal, in order for the Fed to try to stabilize the index, it would have been far more expansive than it actually was. During that period the Fed allowed the money supply M1 to increase at an annual rate of 13 percent. Presumably the actual rate of money growth would have been far higher had the Fed been following the Angell prescription.

So my question to you is twofold. Had you been on the Board would you have pushed for a more expansive rate of money growth than the 13 percent we had during that time to prevent commodity prices from falling; and second, is there some upper limit in money growth that you would not be willing to tolerate regardless of declines in commodity prices?

Dr. ANGELL. Senator Proxmire, the answer to that question is that the Federal Reserve, since I wrote my paper on July 5, has followed a policy almost identical to what I would have wanted them to follow with regard to that price level rule. That is, it seems to me that the Federal Reserve has done what I wanted, not only with regard to commodity prices, but also in terms of exchange rate intervention.

Senator PROXMIRE. Do you favor that 12 or 13 percent expansion in the money supply over the last 11 months or so?

Dr. ANGELL. I always feel very concerned about looking very carefully at any rates of M1 growth in that magnitude. I want to be sure that we're not just engaging in rationalization, which would result in our getting into another inflationary period. But I am equally concerned that if we slow this economy down, and we continue to experience international commodity inflation the way we have, we are on the verge of disrupting the economy. We're certainly then going to make matters tremendously difficult for you under Gramm-Rudman—that is, if we get the economy too soft or

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too slow, that's when we're most apt to engage in overstimulation of M1. I believe that accommodating, as the Federal Reserve has accommodated, the M1 growth path has been pretty close to being on target this last half of the year.

I was only critical during the periods when they were not responsive. I believe the Federal Reserve has properly been responsive since July 5 to what I wrote on July 5. I'm not egotistical enough to believe that they read my paper and decided to change policy because of it, because they have many intelligent people who are able to develop policy who were already there before I was nominated.

Senator PROXMIRE. Now you say:

> Money aggregates in and of themselves indicate how well or how poorly the Fed is doing in maintaining an appropriate supply of money.

You then go on to say:

> Federal Reserve policy must not ignore the growth of the monetary aggregates but a monetary rule cannot be the only intermediate monitor for achieving a stable price level objective.

Dr. Angell, what other intermediate monitors would be used for evaluating monetary policy? You seem to elsewhere in your statement discard real GNP, targeting unemployment. What measures would you use?

Dr. ANGELL. It's largely a matter of semantics, it seems to me, as to whether or not we use commodity auction prices as kind of feedback or information loop or whether we use them as an intermediate target. I never really specified using them as an intermediate target, because if you do that then you end up with the difficulty of having more than one intermediate target and when you end up with more than one intermediate target, it really lets the Fed do about whatever it wants to do. In that case, I believe we're not as accountable to the marketplace or to the Congress as we should be.

Senator PROXMIRE. Dr. Angell, tell me what are the other intermediate targets? That was the question.

Dr. ANGELL. I suggest that M1 is still our best intermediate target. I do not want to use interest rates as an intermediate target.

Senator PROXMIRE. But you say it shouldn't be the only one. What should be the others? That was my question.

Dr. ANGELL. I think I'm suggesting that I prefer that the commodity index be used as an information variable and feedback loop, in order to adjust a single M1 target, rather than to have multiple targets. I think multiple intermediate targets have some policy difficulties that make them not very accountable.

Senator PROXMIRE. My time is up, Mr. Chairman.

The CHAIRMAN. Senator Sasser.

OPENING STATEMENT OF SENATOR SASSER

Senator SASSER. Thank you, Mr. Chairman.

Dr. Angell, I want to welcome you before the committee this morning and I want to commend you for answering the questions that have been propounded to you this morning. It's refreshing to find someone coming before this committee for confirmation who actually lets us know what their views are on the very important

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matters to be dealt with. I want to commend you for it and I find myself in substantial agreement with what you said—not total agreement—but the important thing is at least we know what your perspectives are on some of the issues you will be grappling with in the future.

I also want to say that for the past 4 years, every time we've had a Federal Reserve Board nominee come before this committee, I've had to point out that that individual had no agricultural expertise. I joined with a number of other Senators some years ago in sponsoring a sense of the Senate resolution calling on the administration—at that time it was a Democratic administration—calling on the administration to ensure that the next nominee to the Federal Reserve Board had a background in agriculture, who could in some way represent the interests of the agricultural sector of our economy, bringing those views into the board room when the Federal Reserve Board had a meeting. I'm delighted to note that you have been engaged for 30 years in a farm partnership. You know something about the agricultural sector of our economy, which is in a critical situation now, as you know—indeed, in a crisis situation, in my judgment and in the judgment of most agricultural economists.

Over one-quarter of this country's commercial banks are agricultural banks. They play a vital role in rural communities all across this country. They do in my State of Tennessee as I suspect they do in your State of Kansas, and I hope they will continue to do so. But, unfortunately, these farm-related banks have been distinguished significantly in the past year or two by representing a disproportionately large share of bank failures.

Now, troubles at this level in our farm banking system can spell trouble nationwide. Nationally, commercial banks provide about $40 billion of the operating debt to finance farm production expenses. These commercial banks are therefore a vital element in farmers' ability to obtain financing for their farm operations. We have seen, in some areas in the Southeast, that when the farm bank goes under the farmers—the solvent farmers—have great difficulty finding financing.

Total farm debt now stands at $215 billion. Over 850,000 farmers, roughly half of this country's farmers, accounting for 40 percent of all food production, had negative cash-flows in 1984 and they cannot meet operating expenses from farm earnings. Out of this group of farmers, 215,000 have critically high debt-to-asset ratios and face the likelihood of bankruptcy during the next year.

FAILURES OF AGRICULTURAL BANKS

Now we passed legislation last year to help the Farm Credit System, but this bill does not address the problem of the small rural banks. These small rural banks and farm banks are directly linked to the overall health of the agricultural economy, and we have seen these banks now starting to fall like flies. In 1984, of the 79 bank failures, 32 of them were agricultural banks. This has not gone unnoticed. As you may know, a report prepared by economists at Wharton Econometrics this past summer suggests that this trend of failures could have a ripple effect throughout the banking community. The report concludes, "The continued failures of small

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farm banks could 'spread through the banking system like a contagious disease,' eventually causing the financial system to collapse." So said Wharton Econometrics.

I'm interested, Dr. Angell, in what you see as the short- and long-term future of these ag-related banks and how regulators should respond to their difficulties? That's a big question.

Dr. ANGELL. Thank you, Senator Sasser.

I think it's very important—and I was taught this by my father on the farm—that we ought always to prepare for the worst of times and expect the worst of times and then be surprised when things are better.

I think it would be irresponsible for us not to recognize the seriousness of the difficulties which you so well enumerated. Those difficulties are there.

I would point out to you that we do have many ag banks that have been very well run and are continuing to supply credit and have done a good job of discerning between those projects that would have the cash-flow that would pay back the interest and the principal. So I want to commend the rural bankers who have done a good job.

But I want you to understand, as I know you do by your question, that business cycles and economic condition cycles are not just due to monetary policy; we can have a perverse regulatory cycle. That is, rather than the regulators being far-seeing—just because they happen to be members of some Government agency—these regulators were looking at these farm loans in their heyday, when prices of farmland was going up at rapid paces and farm machinery prices were rising. The regulators were just as willing to say those loans were fine and dandy at that time, and then, when the farming community got into difficulty, all of a sudden the regulators and examiners thought that every farm loan out there must be a bad loan.

We are now in a dangerous period in which we dwell upon the farm credit that's not good and begin to assume that maybe some other lending that might be workable is no longer workable. We have regulators who are worried about their own butts; that is, whenever we have a bank that fails, then somehow or other regulators think they messed up and the Congress may call them in and say, "What did you do? Why weren't you looking at that? How did you let Penn Square get where it was?" So then we have a swing from being too gentle in our examination of banks to the extreme of questioning every agricultural loan that's out there. In doing this, the examiners could be duped into shutting off the entire process of extending credit.

The Secretary of the Treasury seems to understand that the world's economic development and the world's ability to repay debt means that we cannot shut off all international credit. I understand that. We can't have the whole world economy go along with an abundance of credit and then, all of a sudden, cut them all off and think that those debts are going to be good. The Secretary of the Treasury understands that.

But why doesn't he also understand, for our farm community, that we can't go along with credit and then shut it all off and shut it all down?

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I am most concerned, Senators, that we have many rural bankers out there who are tired and sick and want to give up. They want to quit. They are sick of being bankers. Senator Gramm talked to me and mentioned to me about having a banker run a farm. Well, let me tell you, in our case, we borrowed money on our farm machinery in order to buy the bank and that bank worked kind of well, because we injected some money from the farm in it. We've been very fortunate on our farm to be able to operate as we have and to be able to have in a sense profits in our operation year after year. But the fact of the matter is, we are just about to lose people who want to be bankers. If we lose these people who take private capital and risk capital and go into rural communities and make loans, and we have such a perverse regulatory climate that no one wants to be a banker, then I guarantee you that agriculture is going to decline.

I think it's time for us to recognize that the Congress may want to infuse credit into the Farm Credit System, which never did a good job at all of looking at those debts, and ignored the commercial banking industry where private risk capital has been on the line.

UNDUE PRESSURE ON BANKERS

I want to do everything I can to encourage people to understand that regulators are not running the banks. I have bankers that tell me that they spend one-third of their time answering questions from the regulators.

Now I asked the members of the regulatory committee at the Federal Reserve, I asked them, "Now do you have children? Do you have teenage children?" And they said, "Yes." And I said, "Now what would you do if you had a teenage child who got into a little difficulty? Would you put him on regulatory supervision or would you try to encourage and educate?"

We take adult bankers and we put them in the worst possible light. Do you know what it's like to be examined by a bank examiner? Why it makes a highway patrolman's job look like child's play. They're in there calling the shots and telling you to do this and to do that. And I tell you our market system economy works because we are people who make risk capital work, and we must not cut out the climate where people are ready to put risk capital into the rural segment.

Thank you. I'm sorry I took that long to answer.

Senator SASSER. No, I'm delighted to hear that answer. It was very good. My time is up, Mr. Chairman.

The CHAIRMAN. Senator Hecht.

Senator HECHT. Thank you very much. I've enjoyed your comments. I agree with you on your analysis of commodity prices. How can we stabilize commodity prices with the world situation today in minerals like in South Africa and so on and so forth? How would you rationalize that? How can we control that?

Dr. ANGELL. Of course, we have some commodity prices in the world that are subject to international cartels, such as OPEC. And, when you have an international cartel, as Milton Friedman properly pointed out several years ago, these international cartels are

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bound not to work. But the reason international cartels and OPEC didn't work is because the U.S. Federal Reserve System made dollars more scarce than oil.

What we're seeing now is that cartel was able to maintain prices much longer than they would have been able to if there had been a freely competitive market as we have for agricultural commodities. Right now what we're seeing in oil prices is a time lag in oil price decreases. But I want you to know, Senator, that the entire question of deflation is still a kind of ever-present danger. I've been around a lot of entrepreneurial types who want to borrow money, and I know during the 1960's they said, "You go borrow lots of money and you make lots of money," and during the 1970's everybody wanted to borrow money, too. But today I don't know anybody who wants to borrow money to try to drill oil wells at 28,000 feet when the natural gas coming out would have to sell for $8 per million cubic feet. That won't work any more, and it won't work because the Federal Reserve made dollars more scarce than natural gas.

What we have to do, I think, is to be conscious of the fact the deflation does have a destructive impact upon an economy, and you cannot have deflation at such a pace as to disrupt and break the banking system and all the players in the game.

So I would say commodity prices have already reached their lower limit, and we really ought not to think it's good public policy to have the overall level of prices move down.

We welcome, of course, continued declines in oil prices that reflect their actual scarcity worldwide. They didn't come down when we had the monopoly element there. But we must recognize, as those commodity prices come down, that other prices aren't coming down. We're not trying to use monetary policy to control oil prices. We want to control the whole market basket of commodity prices, not just one commodity.

Senator HECHT. Let's leave oil and go to gold and silver.

Dr. ANGELL. Gold and silver do seem to be rather responsive to speculative notions as to how good the dollar is. I only warn speculators in gold and silver that they're taking a bet in putting their money in such a commodity. Gold bars don't lay any gold coins, and they don't pay any interest, and anyone who wants to own gold is betting that the rate of inflation is going to be higher than the rate of interest you can get on Treasury bills. I think they're making a bad bet, but that's not up to me to decide. They're making a bad bet if we maintain a stable price level.

Senator HECHT. The prime rate now has come down considerably but in my opinion it's still too high if our inflation is 3 to 4 percent which it's been the last 2 or 3 years.

Realistically, the prime rate has never over the last 3 or 4 years been over 3 percent over inflation. Do you see the prime rate coming down to let's say 7 percent?

Dr. ANGELL. I would think that it would be an excellent thing for an economy if conditions justify and the market supports a lower level of prices, and I would point out to the Senator that the prospect of Gramm-Rudman-Hollings was more responsible for a decline in market interest rates than anything the Federal Reserve

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could have done. I commend the Congress in showing their determination to enact that legislation.

I would suggest that further demonstration by the Congress that they take the deficit seriously would be a big help in regard to getting the prime rate of interest and real interest rates down.

I would take the liberty, if I might, of suggesting to you that interest rates are much higher than they need to be also because of loopholes in our tax system. The Congress, in 1981, did not just pass the President's Tax Reduction Program. The President's Tax Reduction Program was a program of reducing marginal tax rates. The House Ways and Means Committee added to that another round of tax reductions which were, by and large, what I would call accelerated cost recovery, and that tax system is one which leaves some of our corporations in this country paying a zero tax.

Now in that environment of high marginal tax rates, plus loopholes, you're going to have the prime rate of interest substantially higher than it would be otherwise, so I support any moves that broaden the tax base and close the loopholes.

It just doesn't make for good policy to have one corporation out there paying zero income tax and have some other corporation in a service sector that can't escape the tax. In that kind of atmosphere, one corporation can go out and buy the other one and use it as a tax shield; the assets of the one company become cheaper for the other company.

I would suggest to you that our tax system is more responsible than any other policy that I know of in regard to the high real rate of interest, and I would recommend to you to consider that reduction. I would even suggest that going back to the Treasury-I proposal, in which we have the double taxation of dividends taken out, would be a big help, because right now we give a tremendous incentive to debt financing of corporations versus equity financing. And I believe the tax system ought to be neutral and let the market decide how much ought to be in equity and how much ought to be in debt. We are giving incentives to everyone to load up with debt, and to takeovers by debt, and it's putting us in a position where our economy is not going to be able to go through tough economic times of high interest rates as easily as when we had more equity financing. I am quite concerned about these trends.

MATTER OF TAX BREAKS

Senator HECHT. There are two types of employers, the Federal Government and private enterprise. You know and I know that not everyone can run a business. But a company is able to expand and create more jobs and put more people on the payroll. If they wish to go out and expand and put more in plant and equipment, more in plants, more in businesses, you don't think they should get a tax break?

Dr. ANGELL. I don't understand why some corporation that is in the position to expand gets a tax break, when we've got a farmer out there who is going broke paying 13.5 percent interest rates and who has zero income and whose aftertax rate is 13.5 percent. We pass deals permitting someone else to engage in investment because of a tax gimmick.

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I favor a policy that creates a level playing field for the farmers who have high incomes with the farmers that have low incomes. I cannot accept it as a fair policy to have people burdened down with debt because they have very little advantage from a tax system in which Uncle Sam picks up a large part of the interest rate.

So, in a sense, I see this great inequity, and I would suggest to the Congress that any tax rate reductions that take place of that type, and any broadening of the tax base, is not going to lead to a recession because the capital markets will take note of it and interest rates will come plummeting down and that will help to save some farmers out there who ought to be saved. Not every farmer in trouble needs to be in trouble. We don't want to lose all these people. Everything we do to cause these tax rates to be high imposes an unnecessary burden upon a disadvantaged segment of our society.

Senator HECHT. If we adopt the budgets required by Gramm-Rudman, and I feel we will, and we keep inflation down to the 3, 3.5, 4 percent area, within 1 year what would you expect interest rates to be, the prime rate?

Dr. ANGELL. I consider it unwise as a potential member of the Board of Governors to make an interest-rate forecast. I have been in the interest-rate forecasting business in my consulting business, and my business seemed to double every year. Senator Proxmire, I wasn't as wise as you, and when I ran for the U.S. Senate I borrowed $140,000 and ended up with that as debt, and there wasn't anybody to come around and help me pay that off. As a professor and as a farmer, I looked at my interest payments and they looked like they were going to exceed my income as a farmer and my professor's salary, and so it was necessary for me to get into the consulting business. In this consulting business, of course, I've learned more than I ever would have learned otherwise. But if I had followed Senator Proxmire's advice, and not spent any money on the campaign, then of course I wouldn't have had that difficulty.

But I would suggest to you that I think it's very, very important that I now remove myself from the position of outside consultant who tells people about interest rates, and that I not do that. That is not, I think, appropriate. I think it's appropriate for me to tell the market how I view the economy and how I go about the process of economic analysis and what basis I would use for changing monetary policy, but I ought not to make an interest-rate forecast.

Senator HECHT. My time has expired, but on the second round may I ask a couple more questions?

The CHAIRMAN. Yes. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

Let me welcome you today Dr. Angell. It's obvious from listening to you that you have strong feelings about these issues and there is a series of areas that I'd like to get into, so I'm going to ask you to try to give me condensed answers if you would because I would like to touch on a lot of areas and obviously I don't want you to summarize to the point where you don't think you're saying what you need to say.

First of all, I'm interested in how you received the appointment. Who interviewed you prior to your selection?

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Dr. ANGELL. Senator Riegle, I have always thought that my personal meetings with people were something that the other person should reveal. I think I would prefer to say that I met with administration officials who were in a position to make this appointment. Now, I'll be glad to answer your questions in regard to what took place at those meetings. I'll be glad to answer them very precisely.

Senator RIEGLE. Well, at the moment I'm not so much concerned about what was said at those sessions because I think that does fall into the area of the nature of the conversation you may have had with an individual, but I don't see any problem with you telling us who you were interviewed by. In other words, I assume there was some kind of a clearance process or some kind of a screening process.

Dr. ANGELL. Yes, there was.

Senator RIEGLE. So I assume you spoke to Donald Regan, for one.

Dr. ANGELL. That is correct.

Senator RIEGLE. Were you interviewed by Paul Volcker?

Dr. ANGELL. Of course I was. I was interviewed by Mr. Volcker. In fact, Mr. Volcker called me on the phone while I was still in Kansas, before I came back, and I had an interview with him as soon as I came back.

Senator RIEGLE. How long were you with Mr. Volcker?

Dr. ANGELL. Ample time.

Senator RIEGLE. An hour?

Dr. ANGELL. It was adequate to do the interchange that we needed to do.

Senator RIEGLE. You seem reluctant to want to be very forthcoming about this. I've heard long answers on everything else, but all of the sudden it sounds like you're running out of gas. I'm not asking you what was said in the conversation. I just want to understand what the process was.

It's a very relevant question because there is a concern about the independence of the Federal Reserve System and I happen to feel very strongly about maintaining it. I don't want it politicized. I'm not suggesting that your appointment necessarily does that, but one of the ways we monitor that is to understand what kind of hurdles people have to jump in terms of who's chosen to come up here to take these seats and it's very important at this point. So it's not a casual question. I think the public has some right to know.

Dr. ANGELL. I understand. My answer is that I have had ample meetings with Chairman Volcker—more than one meeting prior to my nomination and after the nomination, and the meetings were very productive from my point of view. If the Chairman wishes to tell how they were from his point of view, I suggest you ask him.

Senator RIEGLE. Well, first of all, I think that by itself is a constructive fact because the last appointee that we had did not meet with Chairman Volcker, as you may know, and I think that raised a concern for many of us. So at least it sounds as if that base was touched.

Let's get into some policy. When the Fed took this vote the other day on the question of leveraged buyouts where there was some controversy and there was a split vote on the Fed. What's your view on that issue?

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Dr. ANGELL. Even though I wasn't there at the meetings, did not have the benefit of the other Governors' discussion, did not have the benefit of the staff input, I am somewhat of a hard-money populist, and I would like to see a level playing field, so without benefit of the discussion, I probably would have decided with the majority on that vote. I'm not sure that the mergers that are taking place would take place due to market forces alone.

Senator RIEGLE. So I take it that that sort of ties in with some of your earlier comments that very expansionary sort of credit activities multiplying in every direction are something that gives you some concern I take it.

Dr. ANGELL. Yes; it does, but I don't have any stomach at all for a case-by-case intervention by the Government sector in the private market system. I don't like that at all. But this policy it seems to me, is in place, and we ought to have a chance to see how it works before someone sits around talking about changing it. It's a matter of fact, and I think we need to have policy stability.

HUGE CREDIT BUILDUP

Senator RIEGLE. Let me ask you with respect to the credit buildup generally, there are some people around—and you've been in the financial forecasting business so you're sort of a—I shouldn't say forecasting, but financial consulting, so you've obviously been paying very careful attention to these things. But when we look at the runup of fiscal deficits and of course now the ballooning trade deficit, which I think is as severe and even more severe than the fiscal deficit because that's all money leaving the country—capital leaving the country, if you will—then you've got the farm problem which you've mentioned here. We've got problems with the savings and loan industry and certainly a number of banks. We've got consumer credit at the highest level that it's been. We've got the large increase in leveraged buyouts. There's an awful lot of credit extension, it seems to me, in every direction.

I'm wondering, if you step back and look at it in the aggregate, do you have the sense that we're stretched out pretty far at the moment, near our outer limits; or are you of the feeling that this can be digested and managed and that we ought to just keep rolling ahead here?

Dr. ANGELL. We're stretched out pretty far, Senator, and I hope it can be managed.

Senator RIEGLE. You hope it can be managed? So, I take it that the choice of the word hope means that there is some real concern here about managing it and it's going to take some skill to manage it so that it doesn't get away from us.

Dr. ANGELL. I am concerned.

EFFECTS OF GRAMM-RUDMAN

Senator RIEGLE. Now that Gramm-Rudman is in place and presumably we're going to get budget cuts one way or the other—or I should say deficit reduction one way or the other, but presumably budget cuts, as the deficit starts cranking down our target for the coming fiscal year 1987 is $144 billion. Yesterday in the Budget Committee when the Budget Director was there, he indicated that

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roughly $60 billion is going to have to come out one way or the other of the deficit. The President is saying "No revenues," and so presumably it comes off the spending side but we'll see what the mix is.

If, in fact, the Federal budget comes down by $60 billion and we actually hit those targets which the law now mandates, what kind of a monetary policy tradeoff would seem to make sense to you in terms of how the Federal Reserve System might deal with that? Because if it actually happens, that's withdrawing an awful lot of fiscal stimulus and I'm wondering if in fact we're going to get or are likely to get some major downward adjustment in interest rates if it's feasible or desirable or if you see that kind of linkage.

Dr. ANGELL. I think there is a linkage. If the foreign trade drag comes down more slowly than the fiscal stimulus, there will be a tendency of course for the capital markets to recognize that, and without Fed intervention long rates of interest will begin to move down without any covert Federal Reserve action.

But, in that environment it would seem to me it would be far different for the Federal Reserve to accommodate what the marketplace is seeing on interest rates than it would be for the Federal Reserve to be a lead on interest rates. That is, it's not as dangerous in regard to inflation potentials to have the Federal Reserve note and follow market forces. If the Congress could set those market forces in play, there would be many farmers and other small businessmen who would benefit from that direction.

Senator RIEGLE. Well, if everything—if we had a perfect world where everything adjusted the way we might like it to, we wouldn't need a lot of the mechanisms we have, but it doesn't work that way and you've given some illustrations yourself in farming. You've seen it yourself as a working farm businessman.

What I'm concerned about here is that as we start down the track of the automatic budget cuts that will reduce the deficits and with a big bite on the front end here, not immediately but in the coming fiscal year, the $60 billion reduction, many economists that I've talked to across a broad philosophical range predict that if we don't get some measure of lower interest rate that corresponds with that fiscal change, we're going to run into real problems. Maybe it comes automatically and maybe the market does it and maybe the market leads it, but maybe the market doesn't. Maybe there are a lot of other factors that intervene that cause the market to not be able to do it that way and the Federal Reserve System may well have to do it.

I'm wondering if it requires Federal Reserve action to in a sense get some monetary response to the fiscal tightening, are you prepared to be a part of the effort to see that happen?

Dr. ANGELL. Senator Riegle, I do not lack the courage to be a leader if conditions warrant such a move.

Senator RIEGLE. So I take it that you mean by that you're sensitive to that issue, you would watch it carefully, and you would have no qualms about taking whatever actions you thought were needed. And if lower interest rates seemed to be appropriate and if the Federal Reserve System had to lead because market conditions weren't able to, I take it that you would have the stomach for that?

Dr. ANGELL. That is correct.

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Senator RIEGLE. My time is up but I'll have other questions for you later. Let me just say Senator Dodd, Mr. Chairman, had some questions that he would like answered for the record and he had to leave. So if I may, I would like to ask that those be submitted.

The CHAIRMAN. Yes, they certainly will be and there will be a number of questions from other Senators as well that we will ask you to respond to in writing.

Senator Gorton.

Senator GORTON. Mr. Angell, in your opening statement you indicated a belief—and I think I'm quoting you correctly—that exchange rates are more important for inflation than has been appreciated.

I presume—and you can correct me if I'm in error—that this means that you feel that a depreciating dollar is more inflationary than most people have given it credit for and vice-versa. Is that right?

Dr. ANGELL. That's not correct. I tend to believe that if we first choose to stabilize commodity prices, then other countries will be free to follow us in pursuit to a stable price level by watching their exchange rates vis-a-vis the dollar.

My experience in China, Indonesia, and India, from watching these new countries begin to use incentive systems to increase production, is that the dollar hasn't come down against those commodities. What we've had here is an adjustment of other countries' currencies upward against the dollar, because they have maintained maybe somewhat different policies than they might.

NEED FOR A STABLE PRICE LEVEL

I believe it's our responsibility, as the world's means of payment country, to have a stable price level and to let other countries pursue their own exchange rates in a way that would be conducive to that.

When we see, because of an international deflation, the dollar rising against commodities, and also rising in value against all these other currencies, that's a signal to us that we have been a little bit too stringent in regard to supplying money and in regard to the international commodity basket.

Senator GORTON. So the dollar can fall against other currencies without falling against other commodities?

Dr. ANGELL. That seems to be correct, and I indicated that to the people that I talked to last year. I think the record indicates that that has been the fact, that we haven't experienced inflationary pressures by the declining dollar as the gloom and doom people suggested when the dollar started down.

Senator GORTON. Do you feel that would continue to be the case, if the dollar declines against other currencies another 10 or 20 percent? How flexible is that course?

Dr. ANGELL. My guess would be that we are now entering into the segment of the exchange rate where we will not get quite as much protection from commodity price imports as we did formerly, because during the period of voluntary import quotas it was sort of an excuse for the Japanese carmakers to become kind of their own voluntary cartel. They thereby had tremendous profit margins

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built into the cars we were importing. And, as the yen appreciated against the dollar, we then found that those profit margins among Japanese companies began to diminish. Those profit margins have diminished and it would seem to me it would be more likely, if we had another 20 percent appreciation of the yen that we would find the Japanese cars would move up in price.

Senator Gorton, what I'm hoping—fervently hoping, as a farmer—is that the United States automobile manufacturers will understand that when the Japanese car prices begin to rise they will understand the American people are not going to put up with any kind of United States price collusion or any activity of spontaneous coordination in which the United States automobile makers raise the prices of their automobiles.

I believe the American consumer in this environment will not respond. I congratulate the American consumers who understand that when they buy cars they buy them because of price incentives, and I don't understand why U.S. manufacturers do not recognize the very elastic demand for their products. I don't understand it as a farmer.

I'd like to ask them the question but I'm not in a position to do so.

Senator GORTON. I like your answer and I agree. That's the best way that they can become competitive, more competitive, is to let those price differentials go on and not to keep them at the stage they are now.

You did get me a little bit off. It was a very interesting point and I am happy that you made it. You got me a little off the direction which I was pursuing.

I wanted to ask you what you thought of the recent G–5 effort to lower the value of the dollar and whether or not it runs any risk of reigniting inflation. I believe you partly answered that, but why don't you answer that question directly?

Dr. ANGELL. I'm delighted that we finally got around to doing it. As you know, my paper of July 5 called for it, and Treasury Secretary Baker and the Chairman moved in that direction at that time. I just wish we had done it 12 months earlier.

Senator GORTON. But you don't feel that that's an inflationary move?

Dr. ANGELL. Of course not. I would never have supported a move that I thought was inflationary.

Senator GORTON. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Sarbanes.

LABEL OF HARD-MONEY POPULIST

Senator SARBANES. Mr. Angell, what does it mean to be a hard-money populist? I think that's the phrase you used in responding to Senator Riegle.

Dr. ANGELL. I don't really know. I've broken one of my rules. One of my rules is never use labels on myself and here I invented one. My family was part of the homesteaders who, 100 years ago, went from North Carolina to Kansas. The declining prices of that post-Civil War period that lasted for 21 years posed enormous burdens upon the farm community somewhat similar to what we're

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seeing today, and so I'm somewhat sympathetic to the populists, but I'm a hard-money person in the sense that I do not want to use reinflation as an antidote to those woes.

Senator SARBANES. Well, words ought to mean something. I had always thought that at least historically and in perception being a populist did not encompass being for hard money. Is that an inaccurate view?

Dr. ANGELL. You have a very good sense of history. Let me suggest that we, of course, had almost a 100-percent increase in commodity prices during the Civil War. After the Civil War, the United States chose to turn gradually to a gold standard at the pre-Civil War exchange rates. Another alternative would have returned to a gold standard after the Civil War at a new gold parity, rather than going back to the old one and not having to roll out that inflation to get it clear back down.

Consequently, you could have been a hard-money populist at that period of time, which would have meant you would have advocated gold prices based upon the then appropriate equilibrium exchange rate, rather than putting the U.S. economy through a long deflationary period.

Senator SARBANES. Was Bryant a spokesman for populism in this country, would you say?

Dr. ANGELL. Yes, he was.

Senator SARBANES. Would Bryant have bought what you're telling us?

Dr. ANGELL. But Bryant didn't have the advantage of living in 1985 or the advantage of all the economic theory we have today. He was an individual who was speaking out for a grievance as he knew it, and I'm just saying that I understand that grievance.

Senator SARBANES. I think language ceases to mean anything when you start putting together hard money and populism. I'll leave it at that. I think we probably should not put labels on ourselves; we should just address the substantive issues.

Dr. ANGELL. Mr. Sarbanes, I take your correction as being very well-intentioned and very correct and from here on I will not use that phrase.

Senator SARBANES. Did I understand you to say to Senator Gorton that you did not think the intervention in the exchange markets by the group of five, which lowered the value of the dollar, contributed to inflation?

Dr. ANGELL. I do not believe that it's had an impact upon the desirable price level stability goals that I seek.

Senator SARBANES. I think they should have intervened for other reasons, but why wouldn't a lower value on the dollar mean an increase in the cost of imports and therefore contribute toward a rising price level in this country?

Dr. ANGELL. Because of the diminution of credit in dollar terms for countries of the world. We still have a scarcity of dollars in international markets that prompts all the countries to use incentive systems to produce more goods in order to get those dollars.

So there is no sign of overabundance of dollars in the international markets. In fact, it seems to be somewhat the opposite case and, under that environment, there is no ever-present inflation process underway.

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Senator SARBANES. Are imports more expensive now than they were?

Dr. ANGELL. Imports are not much more expensive than they were. That's why we have such a long timelag with regard to the foreign trade. Once the dollar rises to such heights that it begins to take away from American farmers, American manufacturers, and American airplane makers those export markets, once those markets are lost in a world in which every country needs more dollars in order to make their deficit payments, there is not any danger of inflation in that environment.

Senator SARBANES. What's your view on the independence of the Federal Reserve?

Dr. ANGELL. Senator Sarbanes, I strongly support the independence of the Federal Reserve.

Senator SARBANES. To what extent do you think the Fed should coordinate its monetary policy with the view of an administration in office as to what its policies should be?

Dr. ANGELL. I believe the Federal Reserve should use price level stability as its primary goal, and I think the Federal Reserve should be open to communications from the Senate, from the House, and from the executive branch in regard to what policy priorities might be. There is no reason not to have communication and open understanding and, if I might, I would like to go back to a question I really missed—I'll do it on somebody else's time.

Senator SARBANES. No, go ahead.

FUNCTION BEST WITH OPENNESS

Dr. ANGELL. Someone asked me the question about whether or not the Open Market Committee minutes ought to be made available. In my public life, I have always been on the side of openness. I believe that in a democracy we function best when we have openness.

The only question in my mind with regard to the release of FOMC minutes has to do with whether or not the Federal Reserve gives better signals of what we're trying to do by what we do than by what we say. As soon as I know the answer to that question, I'll know whether or not the minutes ought to be published earlier or later, but I would be open to hearing both sides of that issue.

Senator SARBANES. Pursuing this point of the independence of the Fed, I'm interested in how your nomination to be a member of the Board of Governors came about. Could you enlighten us on that?

Dr. ANGELL. Mr. Sarbanes, I suppose since being a director of the Kansas City Federal Reserve Bank I recognized that the Board of Governors was more influential than a district director. I had some aspirations to that, and when Lyle Gramley indicated in a news story that he was not going to finish his term I recognized that there might be an opportunity for someone with a farm background. I let it be made known to a friend of mine, who's a friend of Senator Dole, and that was suggested to Senator Dole, and by and large I was a welcomed rider in Senator Dole's car.

Senator SARBANES. For the enlightenment of others who might have similar aspirations, why don't you sketch out for us how that

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proceeded? These are 14-year terms—not in your instance because you've been nominated to an incompleted term—but these are 14-year appointments. This is a very significant position and I think it's helpful to get on the record how these things come about.

Dr. ANGELL. I guess I find it very strange that I would have pursued so many different vocations and not concentrated totally on any one—economist, a farmer, politician, or banker, or an economic consultant. Then it just happened to be that at this moment in time that wide background that I had seemed to be what some people seemed to be looking for.

Senator SARBANES. After you expressed your interest to Senator Dole, and of course you're from his State, and had him interested, did you meet with administration officials with respect to going in the Fed?

Dr. ANGELL. I met with all the people whom Senator Dole suggested I meet with. I just followed his wise leadership.

Senator SARBANES. Why don't we share that wisdom? Who would they be?

Dr. ANGELL. We have been over this before. I have an integrity question about personal meetings. I believe that if two people who have met want to sit down side by side and tell the press about the meeting that's perfectly sensible. I'll be glad to talk about the tone of what was said at any of the meetings. If you want to suggest——

Senator SARBANES. I'm not asking you for the substance of what was said. I'm just inquiring as to whom you met with in the course of seeking this nomination to the Federal Reserve Board.

Dr. ANGELL. My guess is that you would probably be pretty good at guessing, and I'll tell you whether I met with anyone you ask about.

Senator SARBANES. Did you meet with the President?

Dr. ANGELL. I did not.

Senator SARBANES. Did you meet with the Secretary of the Treasury?

Dr. ANGELL. I did.

Senator SARBANES. Did you meet with the chief of the White House staff?

Dr. ANGELL. I did.

Senator SARBANES. And did you meet with the Chairman of the Federal Reserve?

Dr. ANGELL. I did.

Senator SARBANES. Were there other officials of significant rank with whom you met in the course of pursuing this position?

Dr. ANGELL. I met with Under Secretaries in the Treasury, and I met with other people in the White House and I met with many Members of the Senate. I met in July with Senator Garn and I am most impressed as a citizen of the United States with the quality and integrity of the people that I met with. I was most pleased.

Senator SARBANES. The question is obviously pertinent to the independence question and I don't see any problem with putting on the record the extent of your contacts in seeking nomination to the Federal Reserve. Others who may also aspire could probably use that guidance.

Did you meet with members of the Federal Reserve Board other than the Chairman?

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Dr. ANGELL. Yes, I did, and I met with Gov. Lyle Gramley who was retiring and who happens to be an acquaintance of mine.

Senator SARBANES. Well, my time is up. I thank you, Mr. Chairman.

The CHAIRMAN. Senator Proxmire.

Senator PROXMIRE. Mr. Chairman, at the conclusion of my questioning I was asking Dr. Angell about intermediate targets. I just have one quick question on that. I'm still not sure of your answer on intermediate targets.

You say that the commodity prices should provide feedback information but should not be an intermediate target. You also say the monetary aggregates should not be the only intermediate target at the Fed.

My question is quite simple. What are the other intermediate targets you recommend the Fed should follow in addition to the monetary targets? What did you have in mind? Interest rates?

Dr. ANGELL. OK. No, I did not.

Senator PROXMIRE. You did not have in mind interest rates?

Dr. ANGELL. I would not have put down interest rates, but I would say real interest rates would be a feedback or an information variable.

Senator, if I were rewriting the paper today, I would not have said "other intermediate targets." On reflection, I believe that it's better to have a single intermediate target. I want the commodity basket auction prices to be a measurement of how well we are doing on our ultimate goal.

Senator PROXMIRE. I think you answered the question in saying that if you were writing it again you wouldn't refer to intermediate targets. Does that mean that the only intermediate target would be monetary aggregates? Is that right?

Dr. ANGELL. Well, yes, but the use of M1 target as an intermediate requires some procedure when M1 gets out of its target range, as we did this last year. I don't like to deviate from targets without a reason for suggesting why we should let them go. Why should M1 be permitted to go above its target range? By and large, economists typically focus on income velocity and it has a great deal of time lag. That is, if the income velocity of money is falling, as it has during 1985, then there's an indication that the demand for money has been expanding faster than the supply of money has been expanding and, consequently, we don't have a problem. But doing that, we're looking back over our shoulder at last quarter's data, and I think that we would like to have some information or seek out some information that would give us more precise explanations as to why M1 targets should be permitted to be broken.

Senator PROXMIRE. All right. Let me go on to another one.

GANG OF FOUR

As you must know, there's been a lot of speculation in the press about the Reagan majority on the Federal Reserve Board that's going to happen after we confirm you and Mr. Johnson. You have been dubbed, along with the other three, as the "Gang of Four." Some of these articles implied that the so-called Gang of Four will have their own separate agenda set in concert with officials of the

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Reagan administration and will seek to impose it on the rest of the Board or Open Market Committee.

What can you say about the Gang of Four? Will it become a reality or is it just a product of the feverish imagination of the news media?

Dr. ANGELL. I think it's the most preposterous statement of a writers' imagination and expression that I've ever seen and there is no substance whatsoever to it. I don't know why anyone would ever even think such things.

Senator PROXMIRE. Suppose instead of calling it a Gang of Four they called it the distinguished new intellectual elite. Would you accept that?

Dr. ANGELL. No. I would accept it if they want to include all of the Governors, but I don't want to include just four.

Senator PROXMIRE. You would not expect to have a concerted pro-Reagan administration policy then along with Governors Martin and Seger?

Dr. ANGELL. I have a very long history of being a partisan in seeking office when partisanship is called for. Once I became a member of the Kansas House of Representatives I worked with members of all parties to accomplish what I thought were appropriate ends in the public interest. In this case, I am entering a position that is written into law to be separated from the political process, and at this moment in time I no longer continue in a sense to be a Republican. I have a responsibility to the people of this country and the people of the world to select the best policies we know. And, in doing that in these dangerous times, we need to rely upon the information, the expertise, and the intelligence of all members of the Board of Governors.

Senator PROXMIRE. All right, sir. Now many economists are predicting substantially higher inflation this year. For example, the Blue Chip forecast of 50 economists shows the CPI rising from its current level of 3.6 to 4.2 percent by the end of 1986 and 4.7 percent by the end of 1987.

Given the rapid money growth in 1985 which you say you approve over 11 percent in M1 some economists are predicting even higher inflation than the consensus forecast. One former member of the Reagan administration, Larry Kudlow, says that because of excessive monetary growth prices will soon be rising at the rate of 6 percent or more.

What's your own view of the possible resurgence of inflation in 1986 and do you think the Federal Reserve needs to change its policy to head off higher prices?

Dr. ANGELL. I clearly do not anticipate the same inflation as many forecasters do. I continue to be amazed, Senator Proxmire, that the members of the press and the Members of Congress go back to economists time and time again who have been wrong with regard to the rate of inflation. We economists sometimes talk about unbiased errors, and if we go back and take the last 5 years, take all these economists and line them up, they all have had biased errors, because they have all erred in the same direction for 5 consecutive years. I don't see any reason to believe those people that have been wrong are going to be right in the future.

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Senator PROXMIRE. So you don't think there will be a resumption of inflation.

Dr. ANGELL. Of course not, because I'm going to do all I can to stop it.

Senator PROXMIRE. Well, you're a good man, but you have 1 vote of 12 on the Open Market Committee which will set the policy with respect to monetary policy.

REGULATION OF NONBANK BANKS

Now, yesterday the Supreme Court decided the Federal Reserve does not have the power to regulate nonbank banks. The chairman and I briefly discussed this at the beginning of the session today. The Court said that if regulation was necessary Congress would have to act.

Chairman Volcker has testified many times that all banks should be regulated alike under the Bank Holding Company Act.

Do you agree with Chairman Volcker or do you think it is appropriate to have nonbank banks that operate outside the Bank Holding Company Act?

Dr. ANGELL. I agree with Chairman Volcker.

Senator PROXMIRE. All right, sir. Now recently the Fed moved to apply margin requirements to bond-financed takeovers when the takeover is accomplished by a shell corporation. I have two questions.

No. 1, do you think this is an appropriate use of the Board's margin requirement authority; and No. 2, on a more general level, do you think the current wave of hostile takeovers is on balance doing more harm or more good for the economy?

Dr. ANGELL. I've kind of already answered those questions. Let me indicate very briefly that I am quite concerned that the playing field is not level. I do want market forces to determine capital structures and control of corporations, but I want it to take place on a level playing field.

Senator PROXMIRE. If I understand your answer, you're saying that you think it is not an appropriate use of the Board's authority to provide margin requirements in takeovers; is that right?

Dr. ANGELL. No; I think that a level playing field might require that we have the same standards—that is, margin requirements—for nonbank-financed takeovers that we have for bank-financed takeovers. I want level playing fields in which the market forces are most apt to function efficiently.

Senator PROXMIRE. Then as I understand your answer you favor the margin requirement policy that was proposed by the Board recently. Is that correct?

Dr. ANGELL. Now that it's in place I want to at least give it a chance to see how it works before we talk about it. I think it's a policy action that took place before I was there, and I'm somewhat inclined to think that it wasn't, based on my information, too significant a move.

Senator PROXMIRE. And I apologize for missing the answer that you indicated you've already given, but do you on balance think that the takeovers have been good for the economy or not?

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Dr. ANGELL. I think the takeovers have been so biased by our lopsided tax system that there is no basis to judge whether efficiency is the cause.

Senator PROXMIRE. Now I'm a strong believer in our Nation's decentralized banking system, the fact that we have 11,000 independent banks in this country I think is a great advantage for our economy. It's unique, as you know, in the world. Other countries have four, five, or six banks that do 95 percent of the business. We do not have that. We have great dispersion of economic power and competition.

I am troubled by the wave of interstate mergers which I think will radically alter the character of our banking system and make it more difficult for local businessmen to get credit.

What are your views on that issue? I think you're in an excellent position to speak as a farmer, as a banker, as somebody who's studied this so carefully.

Dr. ANGELL. I prefer permitting States to make their own determination with regard to interstate banking. I do not believe that all wisdom exists in Washington on these matters. I do believe that it's entirely appropriate, and this Senate committee I think has adopted a bill, which says, regarding some loophole to do interstate banking, that it would be inappropriate for a State such as South Dakota to allow within its State on an interstate basis what the State law of South Dakota does not permit its own State.

Senator PROXMIRE. Well, I'm still not sure of your response to my question on interstate banking. Do you think we should pass Federal legislation legalizing interstate branching, regional branching, and interstate branching, or not?

Dr. ANGELL. No; I would favor that issue remaining with the States.

Senator PROXMIRE. Very good. Thank you. My time is up, Mr. Chairman.

The CHAIRMAN. I might just comment on that before we turn to Senator Hecht, of how rapidly that marketplace is changing. Utah is a small State insofar as number of banks go and certainly has no really large banks relatively speaking to the money center banks. I haven't even mentioned this to Senator Proxmire. I'm sure he's aware over the years of the great opposition in my State to interstate banking.

A couple of years ago they passed a regional interstate compact with 10 Western States, excluding California. But to my utter amazement, one day last week both the house of representatives and the senate passed a bill, signed by the Governor, with a 2-year trigger. January 1, 1988, any bank that wants to come into Utah can come in.

So I agree with your thinking. It surprises me that my own State would have done that in such a relatively brief period of time. Nevertheless, that is their decision. Any State that wants to do that should be able to. I would agree with you that we should not impose that from the national level but I would expect, if my State does something like that, you're going to see it happen a lot more rapidly than people think on an individual State basis.

Senator Hecht.

Senator HECHT. I just have one further question, Mr. Chairman.

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You keep speaking about a level playing field. There's one problem I have in my mind the last couple of years which I cannot rationalize and I'll explain it to you and perhaps you can help me on it.

A small bank that went under the last year or two, anyone over $100,000 the Government did not take care of the customer, whereas in the large bank like Continental Illinois, the Government—the Federal Reserve or whatever you might want to say—took care of all the depositors. How can we rationalize that, the difference between the small banks and the large banks and the handling of that?

Dr. ANGELL. I think it's difficult to rationalize, but I do believe that when you examine it carefully the Federal Reserve's role in Continental Illinois, for example, did not save the stockholders; that is, the stockholders lost control of the bank and so I think that's a very fundamental issue.

I think our present policy, in which we have $100,000 deposit insurance and in some bank failures we have individual losses above $100,000 and in others individuals don't lose above $100,000 is very difficult to explain. I think it's an inequity that has to be considered.

TWO-TIERED BANKING SYSTEM

Senator HECHT. Would you want to continue this policy as a two-tiered system of banking?

Dr. ANGELL. I don't like a two-tiered system of banking, but we do begin to have some innocent victims when a regional bank begins to fail. Our two banks very close together, one in Missouri and one in Kansas, would have a deposit in a Kansas City regional bank which I will not name. In that regional bank we have sometimes Fed funds deposits of a huge amount; the payments mechanism necessitates rather large deposits by a rural bank in a regional bank. If a rural bank fails because of its own policies, that's one thing, but I think it would be very difficult for us to let a regional bank fail and take down with it a multitude of rural banks because of that.

I don't consider that to be particularly a city-rural bias. In a sense, the bias is that we kept alive the rural banks who would have failed and stopped a domino effect if the large regional bank were to go down. That's the reality of the payments mechanism, and I think we ought to do all we can to alleviate any appearance of unfairness, as the Senate committee has asked me to do in regard to my finances.

Senator HECHT. But I feel we have roughly 14,500 commercial banks in America, like Senator Proxmire mentioned. This has been very important for the growth of America. Now if a depositor is determining whether he is going to put his money in a small bank or a large bank he starts thinking, if the small bank goes under I'm in trouble but if it's a large bank the Government is going to take care of me. So obviously, if this continues, they would take their accounts out of the small banks into the large banks.

Dr. ANGELL. You have hit on an iceberg and you have looked at it and, frankly, I have so many more problems with this entire

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area. When we have, in a private enterprise economy, Government guarantees of $100,000 on CD's and when we have banks and savings and loans who chose to issue CD's 130 basis points over the Treasury bill yield curve, we begin to encourage speculative activity that's really very unfortunate.

I would like to look at that entire area and, as I do it, Senator Hecht, I will keep in mind your feelings with regard to the level playing field, which I share with you.

Senator HECHT. Thank you. No further questions, Mr. Chairman.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Thank you very much, Mr. Chairman.

First, I want to apologize for not being able to be here for all of your testimony. I'm aware that you've covered a number of issues of importance both to me and the members of the committee.

RESULTS OF A LOWER DOLLAR

One question I understand you were asked earlier had to do with whether the recent realignment of exchange rates, which resulted in a lower dollar, a less strong dollar, would not be inflationary. And I was wondering if you could go into a little greater depth as to why this is so, when a currency depreciates by 30 percent, and so many prices in fact are set at the margin by imports. This is true with oil, with textiles, with steel, and almost any item. It's hard to think of many that aren't set through international competition in trade—farm prices. Why do you feel that the 30-percent drop or so in the dollar isn't going to result in a significant increase in inflation?

Dr. ANGELL. It will not result in a significant increase in inflation if the dollar at the same time that its value versus the yen and the deutschemark is changing, continues to buy the same quantity of commodities as it did previously; then clearly there has been no inflationary impact.

For all the countries in the world except the United States, it is true that a depreciation of their currency versus the dollar would result immediately in more significant inflation problems for them than we would have, because world commodity prices are priced in dollar terms. The world is on a managed dollar standard, and when those commodities are purchased with the same number of dollars as they were previously, then we haven't had a deflation or depreciation of the dollar, but we've had an appreciation of these other currencies against the dollar, which is tied to a stable level of commodity prices.

Senator HEINZ. Well, whether it's a depreciation of the dollar relative to other currencies or an appreciation of other currencies relative to the dollar, taking the yen and the dollar, won't Japanese electronic equipment be more expensive?

Dr. ANGELL. After profit margins are pulled down until the economic profit is zero, we would expect that the import prices are going to have to reflect those changing cost conditions, unless they want to use them as loss leaders, and I presume they might run into some problems if they began to do that with regard to our reciprocal trade agreements.

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Now that we have used up most of those profit margins there would tend to be an increase in somebody's import prices with further appreciation of the yen, but if U.S. manufacturers are in a competitive market and respond as competitors to that market they will begin to gain some economies of scale as we begin to gear up our own output. And if our manufacturers wisely recognize the elastic demand for their commodities and try to gain profits by an increase in output, then we will create many jobs and we're not going to have any inflationary consequence, because the consumer is not going to buy the Japanese import that rises in price if the American-produced product doesn't rise in price. Let's hope in this case that the American producers will understand that better than they have in the past.

Senator HEINZ. That was a long sentence. But the reason I'm a little concerned when I have someone explain to me the way everything is going to work is that sometimes it doesn't happen that way. I think the dollar has been overvalued and I think there have been some serious consequences to this country accordingly. There have been some benefits to the country in pressures that have kept prices low, but these in turn have exerted other costs on our economy.

I hear people saying to us, "Don't worry. There are no costs to the dollar weakening vis-a-vis other currencies," but I remember having this same discussion in this same hearing room back in 1977, and 1978, and 1979 with a fellow named Tony Solomon who was then Under Secretary of the Treasury for International Economic Affairs. I kept saying, "The dollar is weakening. What does it mean?" And he trotted out very thorough economic analyses and said, "For every percentage point the dollar drops, it only means 0.00001 percent increase in inflation." And the next year Secretary Solomon came back and said, "We've revised our estimate and it may mean about a 0.1-percent increase in inflation." And the year after that he said, "Well, we really have had to revise our estimate. Inflation increased a lot more than that every time the dollar dropped by 1 percentage point."

And we tend to forget that there are costs. Now why should we care? There are ways of mitigating those costs, depending on what other policies we adopt. I guess what I'm getting at is, if you knew that in fact there were inflationary pressures being created by the depreciation of the dollar—maybe you think that that's not going to be the case—but if you were in fact convinced there were going to be some serious inflationary pressures, what else would you do?

Dr. ANGELL. I would pursue a much more tight monetary policy, sufficient to prevent the inflation from beginning. I certainly understand the Senator's skepticism and I certainly also remember that same period. I would point out one difference. During that period the world was primarily on a fixed exchange rate system and the world is now primarily on a flexible exchange rate system. A flexible exchange rate system——

Senator HEINZ. Why was it on a fixed exchange rate system? John Connolly floated the dollar back in 1972 or 1973 as I recollect. Why were we still on a fixed rate exchange system back in 1978 and 1979?

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Dr. ANGELL. We were dismantling some of the fixed exchange rate rules, but most of the countries of the world were still on a relatively fixed exchange rate standard in that period of time, and they had not experienced the discipline that floating exchange rates puts upon them; that is, under a floating exchange rate system, in any country other than the United States, the politicians are going to immediately experience expansionary policies that are going to show up in the fall of their currency against the dollar, and that disciplines those countries. Consequently, we have today a world with more potential output expansion than we did at that time. And that's why, Senator, we have not yet experienced much inflation with the fall of the dollar from the level of 161 down to approximately 125.

But I share your concern, and I do not know at what point further adjustments of the dollar against these other currencies would precipitate an inflationary course, and I will look carefully at that as we go along.

Senator HEINZ. One apparent anomaly that's troubled me is this. While the dollar has depreciated—or if you prefer, the currencies of the G–5 have appreciated versus the dollar in the neighborhood of 30 percent or so, including Japan—there has not been a similar realignment of currencies with some of our other major trading partners such as Korea, Taiwan, and I suspect Singapore. I haven't looked at those numbers specifically.

What's the meaning of that?

Dr. ANGELL. The meaning of that is that we are living in a world in which we have incentive systems that are increasing manufacturing outputs in many more countries, and that would mean that as the yen appreciates, then Japanese automobiles will be relatively higher priced versus Korean automobiles, and the Japanese may begin to lose their share of the import market vis-a-vis the Koreans.

Senator HEINZ. But what I meant is how is it possible for those particular currency moves to take place without some kind of an imbalance taking place someplace else? Has the Japanese yen remained stable versus Korea, Taiwan, Hong Kong, Singapore, or has it appreciated or depreciated? What's going on out there?

Dr. ANGELL. My knowledge is somewhat limited in regard to all of these currencies, but to the extent that I do know, it seems to me the yen has appreciated against the dollar and against the Korean currency as well as against the Hong Kong dollar and against the Singapore dollar and others.

Senator RIEGLE. Would you yield on my time just at that point?

Senator HEINZ. My time has just about expired but I would be happy to yield on my 1 second.

Senator RIEGLE. I appreciate that because I just recently have seen the data on the market basket of currency value changes for four countries, Korea, Singapore, Hong Kong, and one other which is not Japan, and the net change in currency value so far is less than 1 percent. So while we've seen some change, as the Senator from Pennsylvania has pointed out is important here, we have not seen it in these second-tier countries. So the data just isn't positive. I thank the Senator.

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Senator HEINZ. I want to also commend Senator Riegle because I only learned that from his international trade report which he sends around to all our offices and I found that one of the more fascinating pieces of information in it.

Dr. ANGELL. There may be some way I can get on his list of mailings so I can see that.

Senator RIEGLE. Consider yourself on the list.

Senator HEINZ. I think you've been signed up.

Mr. Chairman, I can think of plenty of other questions that I could ask but I know that we're running late. I would like to submit for the record and responses certain other questions for our witness.

The CHAIRMAN. We would be happy to do that.

Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

I don't know if you've had a chance yet to read today's New York Times, but one of the lead stories on the front page is on the fact that the U.S. economy grew at a rate of only 2.4 percent in the fourth quarter and the initial estimates of course were higher than that. So this is a somewhat depressing revision in terms of the numbers and doesn't tell us what 1986 is going to look like but in the subheadline here in the New York Times it says, "Trade gap cited by analysts is being part of the reason that the numbers in the fourth quarter were as low as they were," and this follows on directly to what Senator Heinz was discussing with you and I want to get into a serious discussion with you on trade in just a minute, but I want to begin it by asking you one specific question which I'd like to just touch on quickly and then move into the broader discussion.

JAPANESE IN THE GOVERNMENT SECURITIES BUSINESS

Recently a number of Japanese securities firms filed application with the Federal Reserve Bank of New York to become primary dealers in United States Government securities. I'm wondering if it would be your view that Japanese securities firms should be allowed to become primary dealers in the United States Government securities market before United States securities firms are accorded full national treatment in Japan, which they do not have and have been prevented from having, and there is absolutely no sign on the horizon that we're going to have any kind of access to their market of that sort. This happens to be true in virtually every other product area as well but we're just talking now about Government securities.

But would it be your view that we ought to move ahead to allow the Japanese to come in and become primary dealers here in the United States without some clear reciprocal arrangement on the other side?

Dr. ANGELL. I do not prefer that the Federal Reserve System get into the business of licensing and regulating securities dealers. I believe that that market has worked very efficiently and I would prefer not to have the Federal Reserve involved in doing that. I prefer that that question be handled elsewhere.

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Consequently, I wouldn't think the Federal Reserve would be in the position to engage in that activity.

I do understand that it seems reasonable that any time a foreign firm has options in the United States that we ought to use the leverage of that entry to gain leverage for U.S. firms abroad.

Senator RIEGLE. Well, if you're on the Federal Reserve Board your opinion on this issue counts for a lot. This application is before the New York Federal Reserve Board, but I would hope you would examine this and I would hope you would decide to oppose it unless we got equal access arrangements on the other side. In the absence of equal access arrangements, I don't think we ought to open one more door here, particularly in this area, and the Federal Reserve System does have a bearing in terms of this question.

Dr. ANGELL. Then it must very well be then that what's happened here is that the Japanese firm involved is a bank holding company and then it comes under the Federal Reserve Bank of New York's regulation.

Senator RIEGLE. I'd like you to take a look at it.

Dr. ANGELL. OK.

Senator RIEGLE. I want to relate to a couple charts I'm going to show you and I'll hold them up here so you can get the idea. I don't think this problem is understandable if you don't see it in graphic form. I want to show you two charts.

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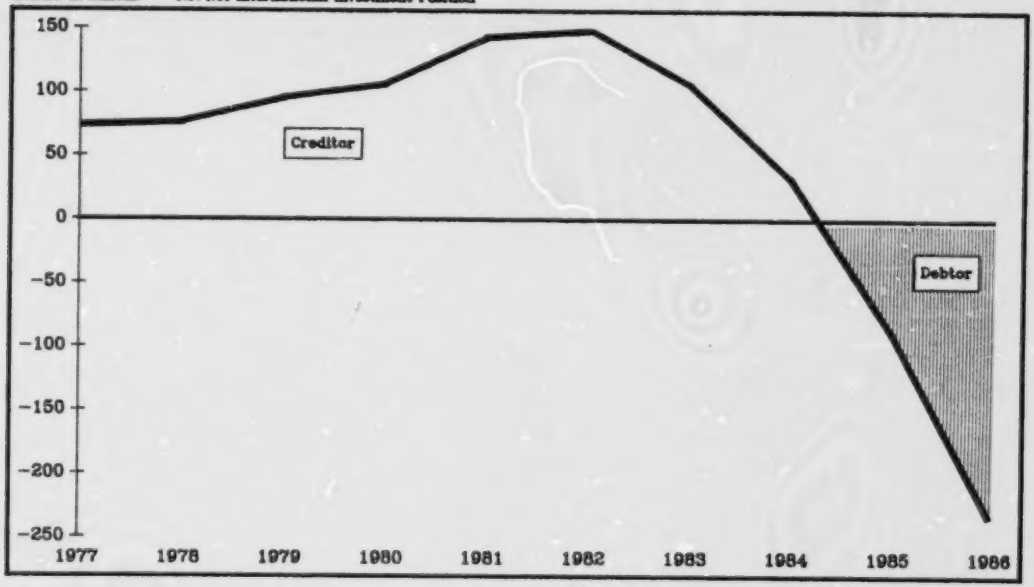
FOR THE FIRST TIME SINCE 1914 THE U.S. IS A DEBTOR NATION

Dollars in Billions — U.S. Net International Investment Position



Office of Senator Donald W. Riegle, Jr.

Source: Economic Report of the President, 1986
Source: OECD, "Economic Outlook", June 1986

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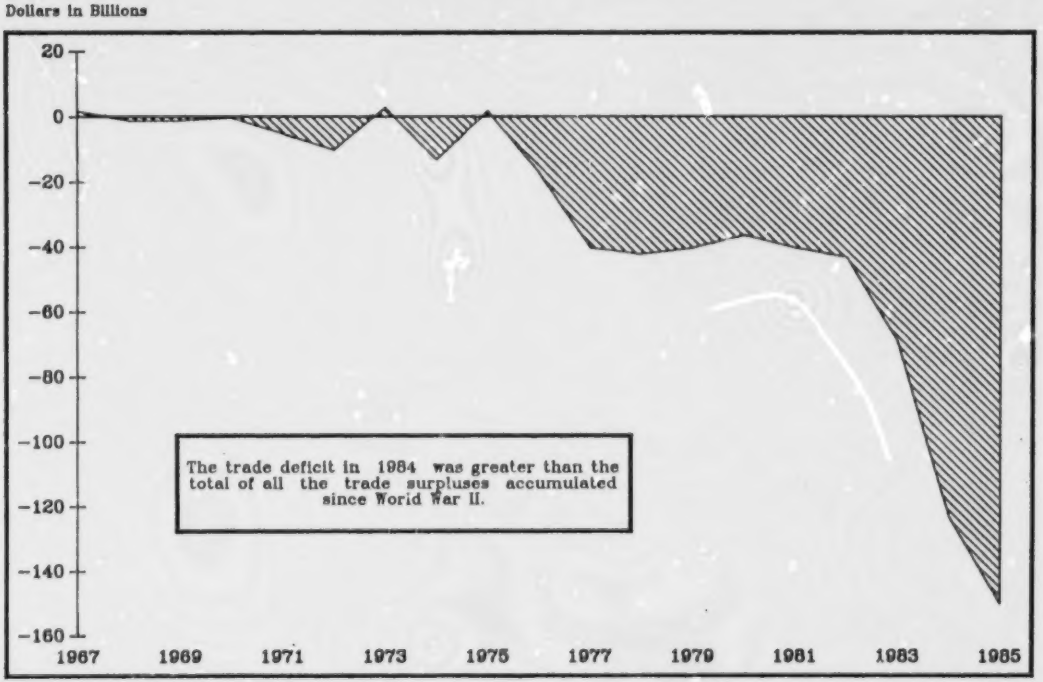
U.S. MERCHANDISE TRADE BALANCE IS DETERIORATING AT AN HISTORIC RATE



Office of Senator Donald W. Riegle, Jr.

Source: Department of Commerce

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One is what's happening to our trade defict over a period of years and you can see that in about 1976-77 we moved into a more adverse posture, but then about 1982 the thing really began to hemorrhage and we have gone into this severe situation where our trade deficit this year is approaching $150 billion and there is no current sign it's going to be any less next year. People are hoping because of the currency valuation changes and so forth that it will happen, but as I've just pointed out with respect to the second-tier trading companies out on the Pacific rim we have not seen any measurable change in currency values after all of the drop in the dollar that we've seen so far.

So in any event, this is what the trade pattern looks like in terms of the trade deficit.

DEBTOR NATION STATUS

If you look at this from the point of view—can you think of that as an income statement and you can think of this as the balance sheet. We have been a creditor nation, as you know, the United States has in the world economy since 1914 until just a few months ago when we crossed the line and we became a debtor nation, joining Brazil and Poland and a lot of other countries in that status. But we are moving into the debtor nation category so rapidly that at the end of about another 6 months we're going to be the leading debtor nation in the world.

Now, Mr. Corrigan, who is the head of the New York Federal Reserve Bank, has estimated that by 1990, 4 years from now, if these trend lines continue, their prediction is that we're going to be a net debtor nation to the tune of at least $500 billion and it could be as high as $1 trillion. I mean, big money and an enormous reversal of fortune in terms of our international balance sheet with other countries.

Now we have not experienced this before and so there's not much science that goes with the question of what this means, what are the implications, can we service that kind of outside debt, what does it mean in terms of foreign investors coming in and picking off U.S. assets, and so forth and so on. But with the head of the New York Federal Reserve Bank expressing concern about it from the point of view of what this means if we move ourselves into that kind of a debtor nation status, has gotten my attention I see it not just in automobiles and heavy industry, but we've had the computer industry—we had a hearing in here that Senator Heinz conducted where we had Intel and the other companies that make the computer chips who are in real trouble, as you may know, and they feel they have been so adversely impaired in the international trading system because they've been kept out of the Japanese market that even if they got access today that wouldn't be sufficient to make them whole again, for they have been permanently damaged. They weren't here to offer a corrective remedy except to say that this problem is spreading coast to coast into virtually every area of production that we have.

I might say it's even happening in agriculture. We are losing foreign markets partly because other agricultural countries have come online and they've got certain other advantages that are

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helping them to give a cost advantage that doesn't necessarily relate to the productivity of the farm units themselves. In Japan today, the prime rate is 5.5 percent, at least the latest data that I've seen is that the prime rate is 5.5 percent. Well, there's a 4-percentage-point premium here in the United States today, plus the poor farmer out there as you well know is not borrowing at 9.5 percent, if he can borrow at ail. He's not getting the prime rate. He's paying something well above prime. So how does a United States farmer or a United States manufacturer compete with a Japanese farmer or a Japanese manufacturer who has the interest rate advantage, plus the closed markets, plus a whole host of other gimmicks and advantages that make us uncompetitive.

I'm not going to, at the moment, get into a long discussion on the auto industry, but we may need to do that because it sounds to me like you understand the farm problem better than you understand the automobile problem and I think if you're going to be on the Federal Reserve Board I want you to understand them both equally. So I hope we can talk about that.

But as you look at these numbers and as you watch us become a debtor nation and you think in terms of how these official estimates that show us being a debtor nation to the tune of maybe $500 billion to $1 trillion in just 4 years, what does this mean to you and is this something that alarms you? Is this something that you have some great sense of concern about as you come on the Federal Reserve Board? Is there anything the Federal Reserve Board can do about it? Does this fall within the purview of the Board as you see it and the decisions that the Board might be called upon to make?

Dr. ANGELL. First let me congratulate you for having such fine charts that illustrate these areas. I'm very pleased a U.S. Senator has the time to become so familiar with these pressing problems which impose upon us changes and transitions.

We cannot go into the future as if this hadn't happened. It means that interest payments are going to have to be going outward and at some point in the future we will have to become a net exporter in merchandise in order to earn the money to pay the interest.

With an interest in agriculture and an interest in automobiles, I think we have a lot of hope here, and that means we're really going to have to become very good at exporting and that means we have to become very good at exporting automobiles as well as exporting wheat. And, Senator, that means we're going to have to be more efficient in producing wheat and corn and automobiles than any one in the world.

I think it's a mistake for us not to have a sense of realization, of hope, of what the American enterprise system can do. I am not about to call off or cut off that sense that we can rise to meet this challenge. With people like you understanding that, I think we will be well on the way to improving the efficiency of American industry and that efficiency, as you point out, has an interest rate disadvantage in regard to the cost of capital and that disadvantage is a rather severe one.

Senator RIEGLE. Well, I think that's an important point to take up because if you take farming as an example, my sense for farm-

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ing today is that American farmers productionwise are the most efficient in the world. That's my perception, that in terms of work—obviously you've got to adjust for differences in price level of imports and so forth, but in terms of being able to produce product from labor, from their own labor and from the other production inputs, American farmers are really at the top of the list in terms of their efficiency.

But that isn't helping them at the moment and particularly as we watch this international agricultural trading system change, as it's changed very dramatically. The embargo had a big impact on it. It closed out certain markets and let other people into the game. Now they're into the game and so forth. And a lot of them are getting help—I'm talking about farmers in other countries—from their national governments through a variety of policies, as are their manufacturers, ranging from computers to video recorders to cars to you name it.

So we are finding now that we're not just pitting the efficiency of a farmer out in Kansas who may work from 4 in the morning until midnight against some farmer in Japan, but that poor farmer out in Kansas or that automobile company in the United States is really up against Japan, Inc., which is sort of a national strategy designed to help their producers and to crush ours, and ours are being crushed bit by bit by bit and those graphs that I've just shown you are an illustration of it. When you've got a trade deficit with one nation of $50 billion, as we do with Japan this year, and which far and away heads the list, you've got a major problem.

But it goes broader than that. Here's the point that I'm getting to. If you look at those costs of inputs with the prime rate—with them having the advantage in Japan of just the 4 percentage point difference—it's almost 100 percent improvement in terms of their situation versus ours. With that kind of a low prime rate and ours being that much higher, obviously they've got a much higher savings rate than we do and that's a problem in this country, how we drive the savings rate up. But it seems to me that you can't ignore the cost of capital—and I'm talking about interest rates now in terms of availability of capital plus what you pay for it—when you're running those kind of differentials, where does the Federal Reserve System come into the act? In other words, when I hear you say that the primary goal is controlling inflation—and I'm all for controlling inflation, I think we've made great progress in that area and I don't think we can afford to surrender it, but I worry a little bit when I hear you say that and I don't hear you balancing that with what you see as the other objectives of the Federal Reserve System. I can see us pursuing that approach in a way that continues to give us high interest rates differentially with other nations that in turn create a cost of production advantage to these foreign competitors who then just wipe us out steadily until they put us in a debtor nation status where we're going to be working day and night just to pay off the interest on money that used to belong to us which we then exported to foreign countries in exchange for goods, and they're going to be our bankers. They're going to be holding the mortgages on us and I haven't heard you connect that yet. I haven't heard you somehow get beyond just the question of holding down the inflation rate to the question of how

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we make this economy grow faster and what role the Fed has in that area.

I guess I want to hear you say that. I want you to relate that to this trade disaster that's overtaken us.

Dr. ANGELL. I appreciate very much your analysis. Let me suggest that I do believe there is a transmission mechanism between monetary policy and real output. Now strict monetarists do not hold that that takes place. I hold that it takes place in the following sequence: That whenever the expected inflation rate is higher than the actual inflation rate, the real sector is going to have a decrease in output because the car manufacturers with the expected rate of inflation are going to build into their cost structure and that of their suppliers the expected inflation rate. When the actual inflation rate turns out to be less than the expected inflation rate, you have a depressing impact upon the U.S. economy and, by and large, what we've failed to be able to do is to communicate with credibility that we really are stopping inflation. We continue to have unknowing forecasters predict higher rates of inflation than we're going to have, and as long as that occurs we're going to have slow growth rates, as were announced for the fourth quarter.

A 2.4-PERCENT GNP GROWTH RATE IS NO SURPRISE

A 2.4-percent real GNP growth rate does not surprise me at all. I had some discussion with certain members of the Council of Economic Advisers who told me that the rate of real output in July was going to be, for the second half, 4 percent, and I told them that I thought it would be 2 percent, and so I'm not surprised at these numbers. The reason for this is because we continue to expect a higher rate of inflation than we have. It's very important that the Federal Reserve have the credibility to bring down not just the actual rate of inflation, but the expected rate of inflation, because that has so much to do with output.

Economic efficiency will occur in automobile factories in Kansas City; by the way, we are a rather substantial assembler of automobiles that your Detroit manufacturers wisely established in Kansas City many, many years ago. We are not a johnny-come-lately in automobile production. But if we pursue price level stability, then the American ingenuity of our management and our labor force can focus upon efficiency. I think that those two go hand in hand, and that has to be the long-run solution to the problem, rather than just a patchwork solution.

Senator RIEGLE. My time is up. Mr. Chairman, I've got a couple of other things when it's appropriate.

The CHAIRMAN. Senator Hecht, do you have any additional questions?

Senator HECHT. No, Mr. Chairman.

The CHAIRMAN. I'll return to you. I hope you could proceed as rapidly as possible.

Senator RIEGLE. I will, Mr. Chairman.

The CHAIRMAN. We have another nominee waiting in the wings.

Senator RIEGLE. I appreciate that and we're all busy and have other things to do, but I think the job that you're being asked to fill is one of the most important in the country. I view it today as

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probably more important than almost any Cabinet position because of the critical role the Fed is going to play out over the next several years in working us through these enormous transitions in this changing world economy, things we don't even understand yet. The old textbooks I studied in good colleges not very long ago aren't even relevant to the kinds of circumstances that we're seeing today.

You made the point at least once—more than once actually today—that you see price level stability as the primary goal of the Federal Reserve Board. You made that clear and where you're coming from.

What would you see as to what goes with that? I'm talking about just the principal goals of the Federal Reserve Board or obligations or responsibilities, if that is the primary one in your view, what two or three or four or five others go with that to really comprise your concept of what the Federal Reserve Board has to do for this country?

Dr. ANGELL. By focusing upon this primary goal, the Federal Reserve creates a climate under which other improvements are most apt to occur. In other words, the encouragement by having the unemployment rate fall as it has during this year—whereas the famous Okuns law would have said that unemployment rate should have risen during this period rather than fallen. The natural unemployment rate in the United States has fallen, I believe, for demographic reasons and because of impact upon the labor force—we are now beginning to get through more flexibility in wage rates. The natural rate of unemployment is falling, and the actual rate of unemployment can thereby fall without engendering a labor shortage.

I believe in this market that we're going to expect to see—with any improvement whatsoever in our real output, and if real output could move up to the administration's hoped for target of around 4 percent—some real significant employment gains. They're going to continue, and the unemployment rate, I believe, should be able to fall rather substantially.

I think it's important to remember that the natural rate of unemployment is on the downswing because we have no longer had the input of so many women who have decided to enter the working force all at once, and we now have fewer people in the high school and college graduating classes, so that proportion of the population tends to bring down the number of entrants in the labor force and that's very, very encouraging news.

But I believe that the Federal Reserve, if it does its one job well, can help foster the other jobs that need to be done by other sectors.

UNEMPLOYMENT RATE

Now let's look at the unemployment rate again. Natural unemployment rates are due to microeconomic forces, not to macroeconomic forces, and we cannot lower the unemployment rate below its natural rate without permanently increasing the rate of inflation. We've been through that many times before.

Senator RIEGLE. Well, on just that point, we're roughly at 7 percent now, just a little bit better than that, as we calculate the

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number and we've got a lot of things that have impacted this that we haven't mentioned. Obviously, the major break in commodity prices not unrelated to the improvement in the inflation outlook but certainly this abrupt drop in the price of oil and a lot of other commodities have had a major effect on how we've been able to keep the inflation down and still get growth here as we go along.

But if the unemployment rate starts to go up—you know, we've had sluggish growth around the world. Our number for the fourth quarter isn't the only one. There are others, too. So you've got a lot of slack in the system around the world which I think has caused us to see less inflationary pressure and less demand on commodities and so forth. That can all change. But if we find at a later point—let's say you're on the Federal Reserve Board and we're 1 or 2 or 3 years down the road and unemployment starts moving up for whatever the combination of reasons, if we get up to 8, 9, 10, or 11 percent, where we've been not all that long ago, and it becomes clear that—and interest rates are high and the high-interest rates at that time are having the effect of in a sense starting to choke the economy in certain ways and in a sense feeding into the growth in the unemployment rate.

Would you be the kind of a Federal Reserve Board member that at some point, even given the primacy of the goal for keeping your main focus on the stability of price levels, might you start to feel at some point if the unemployment rate got up into those ranges and the deficit started climbing because we lose about a $30 billion swing on the deficit for every 1 percent increase in national unemployment—we get up in the 9, 10, 11, or 12 percent unemployment range, do you think you would be inclined, as a Federal Reserve Board member, to want to pay more attention maybe to liquidity of the money supply and making sure interest rates are lower and that you're really inducing wheels to turn whether they're combine wheels or factory machinery or whatever it is? At what point do you start to shift off the question of keeping that zero inflation rate to the point of saying I don't want this economy stalling out, I want it to continue to function. Where would that be? Is it when unemployment gets into the double digit range or where does that start to cause you concern? I mean, you come from the breadbasket of the country and I'm interested in how a Kansas perspective and your background where you see that equation starting to change and how that would affect your policy judgment?

Dr. ANGELL. Senator Riegle, I find it very difficult to answer your question because—being a student of financial history—I just can't perceive getting into the situation of rising unemployment if we have stable price levels. I just do not know of any instance in American history where we have ever had rising unemployment rates following stable price levels.

If the Federal Reserve does its job of maintaining a stable price level, we will not set in motion those forces that require us to adopt policies that lead to higher interest rates and rising unemployment.

Senator RIEGLE. What about falling price levels? You've got falling price levels for land values today.

Dr. ANGELL. I understand that.

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Senator RIEGLE. So it isn't just a question of sort of rising prices or stable prices. You can have a deflation. In fact, we've got a lot of deflation in a lot of areas right now. But it seems to me that if you go back, say, to the 1930's and to other periods later than that in our history, we've had situations where we've had high-interest rates and inflation hasn't necessarily been out of control but we've had high unemployment.

Dr. ANGELL. Yes.

Senator RIEGLE. So you don't always get it in the same pattern. I guess what I'm concerned about, I would be very reluctant—now this is my own view—I would be very reluctant to see this country take a hard long recession any time soon and I say that not just because of the human suffering that would go with that but because I think there's a lot of structural weakness. We're seeing it in the farm sector and we're seeing it in this credit expansion all the way around. I don't want to test the lean-year proposition today when I look at sort of the collective-balance sheets all the way around the perimeter of what we have to work with. I just don't want to do it. I don't think it would be wise to do it.

So if we found ourselves in a situation where we started to gravitate into a serious recession, Gramm-Rudman is going to kick in here with automatic removal of fiscal stimulus which could help drive the economy down faster. That was articulated in debate and a lot of people are concerned about that. If we start going in that direction and unemployment starts increasing rapidly and the deficit starts widening and we don't see any real improvement on the trade front, I would hope the Fed at that point would say it is very important to keep this system running; we don't want unemployment at 15 percent because that gives us more minuses by far than any pluses on price stability, and at that point I would hope that with the kind of flexibility that you say you have and the magnetism and independence, even if you're getting phone calls from somebody in the White House who says, "Hang in there, the price level is the only thing," I would hope that at some point you might from the populism side, the label you gave yourself earlier, would cause you to say if this system isn't humming we're going to trade one set of problems for a much worse set of problems and we've got to keep people working and we've got to keep assets employed, not fully, I can't get that down to zero, but I don't think we can afford to see the unemployment rate up above 10 percent for any length of time in this country in the financial condition that we're in, and increasingly in a world economy situation.

So I stress that to you because I think if your bent is the other way there I think you could send us right over the edge here without ever intending to and I don't want us going over the edge.

Dr. ANGELL. Senator Riegle, I aspire to be the kind of person that you describe in regard to being flexible and a learner. All my life has been involved in the learning sequence, and my formal college education was not foremost among the learning experiences that I've had. I would hope that I would not somehow or other cease to be a learner once I enter the Washington scene. I would hope that I would continue to be a learner, and I would hope I would continue to be responsive to new questions that you perceive, and I would

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be happy to continue this discussion with you in the years in the future.

EFFECTS OF LOWER OIL PRICES

Senator RIEGLE. One final thing and that is, here the oil prices have dropped below $20 a barrel and nobody quite knows where they're going, but there are a lot of sophisticated people who think there's no particular reason why they can't go lower, maybe to $15 a barrel, and if that were to happen, if we were to see oil getting down closer to $15 than to $20 a barrel, and as you look at the impact of that in terms of the international financial situation—we've got cases like Mexico that probably stands out foremost but there are others—how much of a cause for concern would that be in your mind in terms of this being profoundly destabilizing to the banking system, to the oil-related sectors in our economy, and the regions in our country and so forth? What would be your view of the implications of oil at close to $15 a barrel?

Dr. ANGELL. Senator Riegle, for 2 years I have felt that a $15 per barrel oil price is very likely. Now my difficulty, sometimes, is I get premature in regard to how soon these events may take place, and it's because of this concern and belief that forces are at work in a deflationary manner that I have been willing to take a somewhat more independent view as to what monetary policy should do.

Senator RIEGLE. But I guess my question is: What are the implications? What follows if that happens? Does that create huge new problems that we'd better really start to get ready for or not?

Dr. ANGELL. It adds to problems we already have because in many ways, of course. In our Midwest we have not only grain production and red meat production but we also have a very heavy industry in oil and energy, so we are very adversely affected by that industry in the Tenth Federal Reserve District and are very conscious of that. And I believe at every level of Federal Reserve activity there is a very clear discussion—at least we had it at Kansas City—concerning oil prices at about every meeting that I attended before voting on the discount rate.

Senator RIEGLE. If some extraneous factor like that comes careening into the picture, a break in oil prices that creates a lot of secondary instability in banking institutions and international financial relationships and so forth, does that kind of thing—are you flexible enough again in your decisionmaking that you are prepared to have the Fed take whatever actions are needed to sort of stabilize things and to maintain some kind of equilibrium?

What I don't want to see on the Federal Reserve Board is a true believer that says we've got to hold to this even if we've got a terrible disequilibrium on here that's sending everything cascading over the side and we're going to hold to this goal come hell or high water. I don't think we're into that kind of situation here and I think we're going to have to be very intelligent, flexible, pragmatic, and I think cautious and wise. I think it's a whole new assignment. I think probably being on the Fed 10 years ago was a lot easier job than it is today.

So I guess I want to assure myself that you are prepared to adjust as necessary here and help the Fed maybe search its way

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through some new ground and policies that it might have to develop that maybe it hasn't had to have in quite the same way before.

Dr. ANGELL. Senator, your point is well taken, and I hope that I would be wise enough to understand the flexibility and have it there when it's needed.

Senator RIEGLE. I thank you. I appreciate the time, Mr. Chairman, and the witness' answers.

The CHAIRMAN. May I say that the Senator from Michigan has certainly outlined the trade deficit problem very well as he has often in the past and I want to assure him once again I still drive an American car. I would not not buy one under those circumstances.

In closing, I want to say there is one more issue that is developing very rapidly beyond the issues that Senator Riegle is talking about. That is in the internationalization of capital markets and the explosion of the zero-bond market. I don't think too many people understand the implications for the financial services industry.

So the committee is going to hold hearings next month. We have invited many different organizations and international witnesses to start to explore this area, because it's had very little attention in the press and I don't think we have answers to those questions. All these others at least we've talked about for a long time. But the internationalization of the capital markets is a very great concern to me.

We appreciate your testimony very much, Dr. Angell. Senator Sasser outlined my feelings very well earlier today. We appreciate the candor of your answers. We have too many witnesses who seem to be either intimidated or afraid when they appear before a Senate committee to express their opinions. The important function of nomination hearings is for us to determine how those witnesses feel, and whether we agree with you or not on all points is not nearly as important as the fact that you have been candid and straight with us so that we can make that determination. I echo what Senator Sasser said, speaking on behalf of the committee; we appreciate the directness of your answers very much.

Dr. ANGELL. Thank you, Senator. I appreciate very much the manner in which I have been treated by your committee. It's a pleasure to be here. I hope to come back again.

The CHAIRMAN. Thank you. You will be back. We guarantee it.

[Biographical sketch of nominee and response to questions of Senators Heinz, D'Amato, Mattingly, Proxmire, Dodd, and Dixon follow:]

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STATEMENT FOR COMPLETION BY PRESIDENTIAL NOMINEES

Name: ANGELL (Last) Wayne (First) D. (Middle)

Position to which nominated: Board of Governors of the Federal Reserve System Date of nomination: October 10, 1985

Date of birth: 28th (Day) June (Month) 1930 (Year) Place of birth: Liberal, Kansas

Marital status: Married Full name of spouse: Elizabeth (Betty) Jean Angell

Name and ages of children: Patrice A. Pickering - 32; Wynne Denise Angell - 29; Ryan L. Angell - 27; Wiley D. Angell - 22

Education:

Institution	Dates attended	Degrees received	Dates of degrees
Plains High School	9/44 to 5/48	Diploma	May, 1948
Ottawa University	9/48 to 5/52	B.A.	June 1, 1952
University of Kansas	9/52 to 5/53	M.A.	June 8, 1953
University of Kansas	9/53 to 6/56	Ph.D.	June 3, 1957

Honors and awards: List below all scholarships, fellowships, honorary degrees, military medals, honorary society memberships, and any other special recognitions for outstanding service or achievement.

Phi Beta Kappa, University of Kansas - 1953

Wall Street Journal Student Achievement Award - 1952

Kansas Bankers Association Fellowship in Commercial Banking - 1955

Masters of Humane Letters, Ottawa University - September 8, 1971

Sibyl Martin Distinguished Professor, Ottawa University - 1985

Distinguished Service Award, Ottawa Junior Chamber of Commerce - 1962

Who's Who in American Politics

Outstanding Educators of America

Memberships: List below all memberships and offices held in professional, fraternal, business, scholarly, civic, charitable and other organizations.

Organization	Office held (if any)	Dates
American Economics Association		1955 -
Urban Fellowship Advisory Committee	U.S. Department of Housing & Urban Development	1970 - 1972
Kansas State Chamber of Commerce	Executive Committee	1966 - 1968
Ottawa Chamber of Commerce	Board of Directors	1965 - 1968
Kansas Council for Economics Education	Executive Committee	1967 - 1975
Program Committee, American Baptist Churches	Chairman	1971
Kansas Baptist Convention	President	1970

Employment record: List below all positions held since college, including the title or description of job, name of employment, location of work, and dates of inclusive employment.

Instructor, University of Kansas, Lawrence, KS - 8/1956 to 5/1958

Assistant Professor, Ottawa University, Ottawa, KS - 8/1958 to 5/1950

Associate Professor, Ottawa University, Ottawa, KS - 8/1950 to 5/1960

Professor of Economics, Ottawa University, Ottawa, KS - 9/1960 to 12/1985

Dean of the College, Ottawa University, Ottawa, KS - 8/1960 to 8/1971

Vice President and Director, Hope Bank, Hope, KS - 10/1971 to 12/1985

Chairman of the Board, First State Bank, Pleasanton, KS - 11/1975 to 12/1985

Partner, Angell Bros., farm partnership - 5/1953 to 12/1985

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Government experience: List any experience in or direct association with Federal, State, or local governments, including any advisory, consultative, honorary or other part-time service or positions.

House State Representative, 10th District - 1/1961 to 1/1967

Chairman Industrial Development Committee, Vice Chairman Water Resources,

Sub Committee, Chairman, Ways and Means (Appropriation) Committee.

Advisory Committee to the Staff of the Board of Governors, Federal Reserve

re Bank Holding Company Legislation and Regulations.

Director, Federal Reserve Bank of Kansas City - 8/1969 to 12/1985

Published writings: List the titles, publishers and dates of books, articles, reports or other published materials you have written.

None

Political affiliations and activities. List all memberships and offices held in and services rendered to all political parties or election committees during the last 10 years.

Vice Chairman of the Kansas Republican State Legislative Campaign Committee - 1984

Member of the Kansas Republican State Platform Committee - 1982, 1984, 1986

Chairman, Republican 3rd District Convention, Kansas - 1984

President Committeeman, Franklin County Republican Central Committee - 1980

Political contributions: Itemize all political contributions of $500 or more to any individual, campaign organization, political party, political action committee or similar entity during the last eight years and identify the specific amounts, dates, and names of the recipients.

Angell for United States Senate - 1978

Qualifications: State fully your qualifications to serve in the position to which you have been named. (attach sheet)

Future employment relationships:

1. Indicate whether you will sever all connections with your present employer, business firm, association or organization if you are confirmed by the Senate.

Yes

2. As far as can be foreseen, state whether you have any plans after completing government service to resume employment, affiliation or practice with your previous employer, business firm, association or organization.

I have no such plans.

3. Has anybody made you a commitment to a job after you leave government?

No

4. Do you expect to serve the full term for which you have been appointed?

Yes

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Potential conflicts of interest:

1. Describe any financial arrangements or deferred compensation agreements or other continuing dealings with business associates, clients or customers who will be affected by policies which you will influence in the position to which you have been nominated.

None

2. List any investments, obligations, liabilities, or other relationships which might involve potential conflicts of interest with the position to which you have been nominated.

First Finance & Investments, Inc. - Sale will be completed prior to assuming office.

Hume Bancshares, Inc. - Sale will be completed prior to assuming office.

Angell Financial Management - Sale will be completed prior to assuming office.

Wayne Angell & Associates - Business will be terminated prior to assuming office.

Wayne Angell, Financial Economist - Business will be terminated prior to assuming office.

3. Describe any business relationship, dealing or financial transaction (other than tax-paying) which you have had during the last 10 years with the Federal Government, whether for yourself, on behalf of a client, or acting as an agent, that might in any way constitute or result in a possible conflict of interest with the position to which you have been nominated.

None

4. List any lobbying activity during the past 10 years in which you have engaged for the purpose of directly or indirectly influencing the passage, defeat or modification of any legislation at the national level of government or affecting the administration and execution of national law or public policy.

None

5. Explain how you will resolve any potential conflict of interest that may be disclosed by your responses to the above items.

Sale of or termination of business as described in question 2, page 5.

Civil, criminal and investigatory actions:

1. Give the full details of any civil or criminal proceeding in which you were a defendant or any inquiry or investigation by a Federal, State, or local agency in which you were the subject of the inquiry or investigation.

None

2. Give the full details of any proceeding, inquiry or investigation by any professional association including any bar association in which you were the subject of the proceeding, inquiry or investigation.

None

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Questions Submitted by Senator Heinz to Mr. Angell
Nomination Hearing -- January 23, 1986

Question 1. Despite many signs of continuing health in the U.S. economy, a number of disturbing imbalances cloud the horizon.

-- The trade deficit is at record levels and still rising.

-- The value of the dollar, although below the peak level of early 1985 in part due to a more active intervention policy, is still at a level commensurate with continuing large current account deficits.

-- And the federal budget deficit, although now subject to limits imposed by Gramm-Rudman, remains enormous.

The U.S. is a net debtor nation and U.S. exporters face tremendous competitive odds. How urgent for the continued health of the overall economy and the U.S. trade position are these steps to correct financial imbalances? Are the steps being taken sufficient?

Answer. High priority should be assigned to correcting the imbalances in our economy. The steps that have been taken so far are movements in the right direction. It is important to follow through on these efforts if further progress is to be made. However, we must recognize that even in the best of circumstances, it will take some time before our trade deficit and the other imbalances in our economy are significantly reduced.

Question 2. Concerns have been expressed that the massive deficit position of the U.S. vis a vis the rest of the world could lead to a loss of confidence in the U.S. economy, resulting in a rapid drop in the value of the dollar and capital inflows, and to a rise in inflation. Actual experience over the last year has been of a gradually falling exchange rate and modest inflation. What do you believe are the prospects for a continued steady decline in the dollar without a notable increase in inflation or the drying up of foreign capital inflows--a so-called "soft landing"? How should monetary policy be used to address a more rapid decline in the dollar or increase in inflation?

Answer. I cannot predict what will happen to the exchange rate of the dollar. It depends on policies here and abroad and on other developments in our economy, in other economies, and in international markets. I do not believe that the decline in the dollar so far will have a significantly adverse effect on our inflation rate. If a further, rapid decline in the dollar threatened to reignite inflation here, I would be inclined to pursue a tighter monetary policy to keep inflation under control.

Question 3. A more active intervention policy has been instituted by the G-5 countries to ensure that the values of the major currencies accurately reflect the relative strengths of their economies. How important do you believe exchange market intervention is to the value of the dollar, and how do you see this more active approach affecting U.S. monetary policy?

Answer. Intervention can at times be useful. However, for intervention to have a significant, lasting effect on exchange rates it must be supported by appropriate macroeconomic policies. For that reason, I believe that the exchange rate should be given greater weight in monetary policy decisions.

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Question 4. The Omnibus Trade Bill introduced in the Senate contains a number of provisions intended to further reduce the value of the dollar. These include:

-- A possible monetary conference to consider improvements to the world monetary system;

-- Enhanced coordination of G-5 monetary and fiscal policies to promote convergence of key economic factors such as inflation, interest rates and money growth; and

-- Establishment of a Strategic Exchange Reserve in which foreign currencies would be accumulated to increase the value of non-dollar currencies and make U.S. participation in foreign exchange markets more effective and credible.

With regard to these provisions, do you believe any significant changes are needed in the monetary system and that a monetary conference should be considered? How important to future economic health is convergence of G-5 policies, and how would you see such cooperation affecting the conduct of U.S. fiscal and monetary policy? Do you believe that accumulation of a foreign exchange reserve would be an effective tool for foreign exchange intervention?

Answer. I share some of the concerns about the functioning of the international monetary system, particularly about the costs associated with medium-term swings in exchange rates, which have given rise to talk about an international monetary conference. However, modifications in selected aspects of the international monetary system are more likely to be achieved by pragmatic adjustments in current arrangements than by convening a conference. A conference runs the risk of raising unrealistic expectations about a massive overhaul of the international monetary system, which I do not believe is required.

After all is said and done for, there is no substitute for sound, non-inflationary policies by all major countries on a sustained basis as the way to achieve greater exchange-rate stability. Consultations within existing international forums--the Group of Five, the Group of Ten and the IMF's Interim Committee--provide avenues for countries to pursue policies that are mutually reinforcing. Discussions in these forums also provide a means of assuring that policymakers take into account the international implications of each others' domestic policies. While a more mutually consistent set of policies among the major economies would be desirable, each country's policies must be designed to suit its particular economic circumstances.

The U.S. Treasury and the Federal Reserve currently possess adequate means with which to intervene in foreign exchange markets, and such intervention can at times be useful. However, it does not appear necessary to establish a special Strategic Exchange Reserve for this purpose.

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Question 5. Despite the decline in the value of the dollar during 1985, the U.S. merchandise trade deficit remains at record levels. Export-led and import-sensitive industries have borne the brunt of the high dollar. Do you believe there has been any permanent weakening of the U.S. manufacturing sector due to the high dollar, and how soon do you foresee improvement in the trade deficit as a result of declines in the dollar during the last year?

Answer. The manufacturing sector certainly has been hurt by the high value of the dollar, as have other sectors, including the farm sector. Some firms are permanently out of business. However, those that remain have been forced by competition to adopt more efficient production techniques; the entire U.S. economy should benefit from this enhanced productivity.

I would hope to see some improvement in our trade position in volume terms quite quickly. However, it could well be late this year or even next year before we see a significant decline in the value of our trade deficit.

Question 6. Given the size of the U.S. trade deficit, there is strong support across the United States for measures to improve the competitive position of U.S. exporters. One such step was passage of the Export Trading Company Act in 1982. What are your views of the export trading company concept?

Answer. Export trading companies can be useful in promoting exports, but the competitive position of a country's exports will depend primarily on fundamental economic factors--notably, a non-inflationary economic environment that promotes savings and investment and a realistic, sustainable exchange rate.

Question 7. Since the original legislation passed, it has become clear that a number of impediments have limited the effectiveness of the law and the impact of trading companies. I have introduced legislation (S. 1934) to provide further guidance to the Federal Reserve on the appropriate relationship between banks and affiliated export trading companies. These amendments would clarify the definition of ETCs and relax certain restrictions on member bank investment in and transactions with ETCs being applied by the Federal Reserve, while fully maintaining Federal Reserve authority to protect the soundness of member banks. Could you comment on these provisions?

Answer. The provisions of S. 1934 appear to be quite technical, and I cannot comment at this time. I would expect to study these issues at a later date.

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Questions Submitted by Senator D'Amato to Mr. Angell
Nomination Hearing -- January 23, 1986

Question 1. On January 8, 1986, the Federal Reserve Board (FED) adopted an interpretation of Regulation G. This interpretation applies the margin requirements of Regulation G to the financing of corporate takeovers through the use of junk bonds. The interpretation represents a departure from the FED's earlier position on this subject.

a) Do you agree with the FED's January 8, 1986 interpretation?

Answer. Although I have not had the benefit of the Federal Reserve Board staff studies on the question or the benefit of the Board discussion, I probably would have sided with the majority on the vote to adopt the interpretation.

b) If you take issue with the January 8, 1986 interpretation, could you please state your position?

Answer. As I just noted, I have no reason to take exception.

c) The interpretation was supposedly limited to certain transactions. What do you perceive to be the limits of the interpretation?

Answer. I believe that the interpretation is limited to a specific, narrow class of transactions that fall within the scope of existing market regulations. The interpretation applies margin requirements to debt securities issued by shell corporations to finance acquisitions of margin stock. As I understand the interpretation, the Board's margin requirements would not apply if there is evidence that purchasers of the securities could rely on assets other than margin stock as collateral; that is, if the debt is issued or guaranteed by an operating company with substantial assets or cash flow or if the debt securities are only issued upon the completion of the merger.

d) Do you think a distinction should have been made between the application of the January 8, 1986 interpretation to hostile takeovers and friendly acquisitions or leveraged buyouts that are financed through the use of junk bonds?

Answer. It isn't clear that such a distinction would be easy to make as a general matter. But, more fundamentally, I would have reservations about using the mechanism of margin regulation to shape "the market for corporate control." To the extent that this is a concern, other instruments of government regulation--for example, securities law--would seem more appropriate approaches.

e) At present, foreign investors who finance acquisitions through foreign borrowing are not subject to the requirements of Regulation G. Should legislation be enacted that would require the application of the margin rules to these foreign investors?

Answer. Regulation of borrowing from foreign lenders is a complex issue, and I would not want to suggest that

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Congress enact any specific legislation until I have had the opportunity to study the issues involved. In concept, I believe that regulations should be applied uniformly and evenhandedly. Applying margin regulations to foreign lenders, however, does raise sensitive issues regarding jurisdictional authority and relations with other governments, a matter requiring care. I would like to point out that the Federal Reserve's margin regulations do apply when U.S. borrowers obtain credit from foreign lenders, either directly or indirectly.

f) Last year a FED Study recommended the repeal or modification of the 50% margin requirement. Do you support the recommendations of this report?

Answer. As I understand it, that study focused on the broader issue of the need for federal margin regulation and the appropriate regulatory body, rather than on the 50 percent margin requirement per se. Given the changes that have occurred in securities markets--and the role of margin credit--over the past half century, such a fundamental reassessment would seem appropriate. I haven't had an opportunity to study the staff report yet, though, and would want to do so before taking a position on this issue.

Question 2. The Banking Committee has been examining the issue of deposit insurance reform for several months. Part of this inquiry has focused upon the adequacy of the minimum capital reserves maintained by banks. Last week the Comptroller of the Currency proposed a plan that would eliminate the current mandatory requirement that banks maintain a minimum 6% capital-to-assets ratio. The Comptroller recommended promulgating new rules that would set banks' minimum capital reserves solely by the riskiness of their investments. By contrast, FED Chairman Volcker proposed calculating capital reserves according to risk but retaining the 6% requirement as a base.

a) Do you believe that the minimum capital adequacy reserves of banks should be increased?

b) Do you believe the plan proposed by Chairman Volcker or that of the Comptroller provides a more appropriate solution?

Answer. a) I am in favor of supervisory standards that require banking organizations to maintain strong capital positions in view of the risks to which banking organizations are exposed. As you know, the Board has established minimum capital adequacy ratios and has tightened these standards for the larger banks over the last several years. Recently, the Board proposed a supplemental risk-based capital measure that is designed to encourage those banking organizations with higher risk profiles to strengthen their capital basis. I support the thrust of this effort and believe that banking organizations should back their risk-bearing activities with adequate capital. The support of risk-taking by a strong capital position promotes the safety of depositors' funds, serves as an additional buffer to the FDIC insurance fund, and can better enable a bank to withstand a period of serious asset or earnings problems.

b) The risk-based measure at this stage is a proposal on which the Board is seeking comment and which may change in light of the comments received. However, I agree with the general direction of the proposal, and that, at least initially, we should not replace the existing minimum guidelines since the guidelines have been instrumental in encouraging banking organizations to strengthen their capital positions. However, over time, as we gain greater experience with a risk-based measure, it may be appropriate to place greater emphasis--and perhaps eventually rely entirely--on such a measure.

Question 3. Congress has been contemplating several legislative proposals that would impose minimal regulation on the previously unregulated market in government securities. Do you believe that the authority to act as the principal regulator should be invested in the FED, the Treasury Department or a self-regulatory organization?

Answer. I am not really convinced that an adequate case has yet been made for government regulation in this market. This is a very liquid and efficient market and it seems unwise to disturb it unless serious and persistent failures have been demonstrated. Most participants in this market are quite sophisticated. To be sure, some, generally less sophisticated, parties were injured in episodes in the recent past, but I think those episodes have had a salutary educational effect that should significantly reduce the likelihood of new problems.

Question 4. At present Bankers Trust Company, Morgan Guaranty Bank, and Citicorp have applications pending before the FED that would permit these institutions to undertake non-banking activities by, in essence, asking the FED to redefine the term "engaged principally" as found in section 21, paragraph 7 of the Glass-Steagall Act. Do you believe that the FED would be acting within its statutory authority by granting these applications and, by doing so, essentially redefining the term "engaged principally"? Shouldn't the definition or re-definition of this term be left to Congress?

Answer. The underwriting proposals now before the Federal Reserve Board concern the applicability of section 20 of the Banking Act of 1933 which prohibits bank affiliates from being "engaged principally" in the underwriting and public sale of securities. Congress gave the Federal Reserve Board the responsibility to administer and enforce section 20 which of necessity includes the authority to interpret the meaning of "engaged principally" in a way that is consistent with the terms of the Act and its purpose. With regard to the particular cases now before the Board, I am generally familiar with the proposals but I have not had the opportunity to study the applications and accompanying documents in detail. Because of this and because of the possibility that, if confirmed, I could be involved in Board decisions concerning these cases, it would not be appropriate for me to express an opinion on the applications. Of course, if the law is not effectively serving the public interest, it is the responsibility of Congress not the Federal Reserve Board to make the necessary changes or amendments.

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Question 5. Last year the Supreme Court held that commercial paper was included within the scope of the definition of a security under the federal securities laws. However, certain banking institutions continue to underwrite and distribute commercial paper. Do you intend to prohibit commercial bank activity in this area upon your approval to the Board?

Answer. The Supreme Court ruled that commercial paper is a security for purposes of the Glass-Steagall Act, which generally prohibits banks from underwriting or dealing in securities. The Supreme Court expressed no opinion, however, on whether the methods banks use in placing the commercial paper of third parties with sophisticated investors constitute underwriting or dealing in the commercial paper securities. In June 1985, the Board ruled that the methods of placing commercial paper used by the Bankers Trust Company, a New York bank, do not involve underwriting or dealing in commercial paper for purposes of the Glass-Steagall Act. This ruling is currently being reviewed in the courts and, accordingly, further comment on this matter does not appear appropriate.

Question 6. Many commentators contend that America has become over-leveraged and that corporations and individuals face a debt crisis of huge proportions. Do you believe that such a crisis situation exists? If so, what action should the FED take to discourage the growth of corporate and personal debt?

Answer. Debt growth has been extremely rapid recently, and is, I believe, a cause for concern. I think it would be a mistake to suggest that we are faced with an imminent, general economic crisis, but certainly many individual firms and households have amassed debts that reduce their financial room to maneuver and could expose them to serious difficulty if their cash flow expectations are not realized.

Some of the leveraging we are currently witnessing is stimulated by features in our tax code that favor debt financing--features which I hope will be reconsidered as part of Congress' work on tax reform. The Fed's chief concern, however, has to be with meeting general monetary needs in line with the goal of promoting price stability in the long run.

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Questions Submitted by Senator Mattingly to Mr. Angell
Nomination Hearing -- January 23, 1986

Question 1. What is your attitude generally toward the Glass-Steagall Act; and what, in your opinion, should the Federal Reserve Board do in this area to prohibit banks from engaging in nonbank activities?

Answer. I'm in general agreement with the proposals of the Board (and the Treasury) to legislate some widening of the powers of banking organizations, into such areas as municipal revenue bond underwriting. I believe that it would be desirable to require that such nontraditional activities be conducted outside the bank, by other affiliates within a holding company structure; while I appreciate the limitations of this approach in sheltering the bank from the impacts of potential risks in new activities, I do see some benefits. In addressing the issue of which activities to permit, I believe consideration should be given to the degree of risk involved and whether there are possible conflicts of interest.

Question 2. Citicorp, Bankers Trust and Morgan Guaranty Bank have applications now pending before the Federal Reserve Board that would redefine the term "engaged principally" so as to allow these commercial banks to engage in securities and other nonbanking activities. In light of yesterday's decision on the Dimension Case before the Supreme Court, which struck down the Fed's redefinition of a bank, what action (if any) do you believe should be taken by the Fed to redefine the term "engaged principally?"

Answer. The proposals you mention concern the applicability of section 20 of the Banking Act of 1933, which prohibits bank affiliates from being "engaged principally" in the underwriting and public sale of securities. While I am not a lawyer, it is not clear to me that the Dimension decision would alter the picture in these cases; Congress gave the Board the responsibility to administer and enforce section 20, which of necessity includes the authority to interpret the meaning of "engaged principally" in a way that is consistent with the terms of the Act and its purpose. Of course, if it is determined that the law is not serving the public interest effectively in today's market environment, then it would be appropriate for the Federal Reserve to ask the Congress for legislation that would clarify its desires regarding the separation of commercial and investment banking. With regard to the particular cases before the Board, while I am generally familiar with them, I have not had an opportunity to study the applications or legal considerations in detail. Because of this and because I may participate in decisions on these cases as a Board member, I feel it would not be appropriate for me to express an opinion on these applications at this time.

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Question 3. What is your attitude generally toward the merger and acquisition activities in the economy, and what should the Federal Reserve Board do in this area?

Answer. If merger and acquisition activity takes place in the context of a "level playing field" where it reflects efforts to achieve, for example, gains in efficiency or improved management and where shareholders and others are treated fairly, there is no strong case for government intervention--apart from normal anti-trust considerations. However, the market today is distorted in a number of ways by a tax code that provides a number of artificial incentives and aids to those involved in mergers, including the favorable treatment given debt financing which has the undesirable side-effect of encouraging the assumption of highly-leveraged--and thus riskier--financial postures. The Congress should address this question as it considers the general issue of tax reform.

Question 4. Will it be your intent to seek reopening of the recent junk bond limitations imposed by the Fed on hostile mergers; if so, why?

Answer. No; I probably would have sided with the majority to adopt the interpretation which applies the margin requirement to a narrow range of financing arrangements involving the use of shell corporations.

Questions Submitted by Senator Proxmire to Mr. Angell
Nomination Hearing -- January 23, 1986

Question 1. Fiscal/monetary policy mix. I would like to get your view on the interplay between fiscal and monetary policy. One view suggests that monetary policy should be influenced by fiscal policy. That is, if the President and the Congress are pursuing a loose fiscal policy, the FED needs to temper the effect with a tighter money policy. Those who hold this view argue that if the federal deficit can indeed be cut through Gramm-Rudman, that the FED can then loosen up on the monetary reins.

The opposite view suggests that monetary policy should be conducted with a view towards long-term price stability and stable growth and should not be influenced by fiscal policy.

What is your view on this issue?

Answer. Indeed, over the long term the Federal Reserve should focus on achieving and maintaining stable prices. With monetary policy directed at that goal, reductions in the federal budget deficit would lower interest and exchange rates as the federal government reduced its competition with the private sector for credit. Credit-sensitive and foreign trade-sensitive sectors would grow faster, and thus help to maintain economic expansion. I think we need to be cautious about attempting any "fine-tuning" by monetary policy, but I would certainly want to monitor developments carefully to make sure that some short-run adjustments are not needed to keep the economy on an even keel as the fiscal direction is altered.

Question 2. Stabilizing the Exchange Rate of the Dollar. You say that one of your chief criticisms of monetary policy over the last several years is that it allowed the exchange value of the dollar to appreciate by over 70 percent, thereby destroying many of our export markets. You recommend that the Federal Reserve intervene actively in foreign exchange markets to stabilize the value of the dollar against foreign currencies. I have some trouble with your proposal on two counts:

(1) Pegging the dollar to some arbitrary exchange rate could require a massive increase in the money supply to prevent the dollar from rising, thereby laying the seeds of rampant inflation;

(2) In the view of many economists including President Reagan's former chief Economic Adviser Feldstein, the principal reason for the rise of the dollar is due to our uncontrolled budget deficits. If we say the value of the dollar on foreign exchange markets is mainly the responsibility of the Federal Reserve, don't we give a free ride to the President and the Congress to continue their irresponsible fiscal policies that got us into so much trouble?

Answer. I do not believe that we should try to peg the dollar to some arbitrary exchange rate, or that the exchange rate should be the sole objective of monetary policy. Rather, I believe that the exchange rate is one factor among many that should be taken into account in determining policy. When it seems too high, some intervention and somewhat easier monetary policy would seem appropriate. However, the Federal Reserve is not the only body that should be concerned about exchange rates.

The impact on the exchange rate of the large federal budget deficits is only one reason for those deficits to be reduced. Other imbalances in our economy and the world economy also have been generated by our deficits; these other imbalances provide ample cause to act promptly to reduce our budget deficits.

Question 3. On July 17th 1985 the New York Times carried an article entitled "The Market for Latin Debt" in which it is stated that many banks with Latin American debts are finding relief by selling them in a secondary market. The article noted that several of the big money center banks have refused to discuss this development. It then said, "One reason for the reticence of the bankers and brokers is that the transactions provide tangible evidence that many Third World loans are not worth their face value and the big banks fear that the regulators would cite that as a reason to require loan loss reserves."

In May of 1985 the banking committee of the American Institute of Certified Public Accountants ruled that banks that swap loans must discount the loans on their books if they received less than face value.

Do you agree with that ruling by the accountants? Do you think if the market is saying that various of the third world loans are not worth their face value this is a good reason for the regulators to require additional reserves against such loans? Do you think that the regulators should make the banks set aside reserves against any loans that are swapped for less than their face value?

Answer. The ruling by Certified Public Accountants appears reasonable; I understand it applies only to those portions of loans that are actually swapped. Banks may swap loans for many reasons, and the market for such loan swaps is reportedly thin.

Bank regulators should require reserves (either general loan loss reserves or allocated transfer risk reserves) on the basis of thorough evaluation of the loans and of the situations of the debtor countries, rather than solely on the basis of a relatively few transactions.

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Question 4. Targeting real GNP growth. Some FED watchers have suggested that regardless of what the FED says it is targeting, it is really targeting real GNP growth. That is, when the FED thinks the economy is growing too fast in real terms, it steps on the monetary brakes, and when it thinks the economy is growing too slow, it steps on the monetary gas peddle. My question to you is two-fold:

(1) Do you think this is an accurate description of how monetary policy is actually made?

(2) Do you think the real rate of GNP growth is an appropriate target for the FED?

Answer. Although I haven't yet participated in FOMC deliberations, I can say that, as a director of the Federal Reserve Bank of Kansas City and a longtime observer of monetary policy, it is my perception that monetary policy is not targeted on real activity. In view of the many uncertainties in recent years about the money stock and other financial guides to policy, though, it is evident to me that the FOMC has, of necessity, placed more emphasis on the underlying course of economic expansion as well as other economic variables in assessing the stance of policy. In my view, because monetary policy influences the economy only over a span of time, an effort to "fine tune" GNP growth could actually prove destabilizing. Rather, I believe that the appropriate policy objective should be to stabilize the price level over the long run.

Question 5. Rules vs. Discretion in monetary policy. There has been considerable debate in the last few years about whether the Federal Reserve ought to be allowed any discretion in the conduct of monetary policy. Those against discretion argue that a discretionary policy is inherently destabilizing and that monetary policy ought to be conducted according to a strict rule. The nature of the rule varies from some measure of money to some measure of price such as gold, foreign exchange rates or commodity prices.

Those against a rule-based monetary policy argue the economy is too complex to be run in accordance with a simple rule. They say that any rule will not cover all the situations arising in a dynamically changing economy and that the monetary authorities must be allowed discretion.

Without getting into the question of what is an appropriate rule, where do you stand on the question of discretion versus a rule? Should the Federal Reserve be allowed discretion, or should we seek to constrain its policies with a rule?

Answer. In concept, there is much to be said for a rule that would govern the conduct of monetary policy. Ideally, such a rule would guide policy action consistently in the direction of achieving the goal for which the monetary authority has unique responsibility--domestic price stability--and would minimize the possibility of errors in judgment and reduce uncertainties on the part of the public as to the stance of monetary policy. Over the years, many rules have been held out as offering such benefits, but given the many changes affecting our financial system and economy they all have serious shortcomings and run the risk of being destabilizing if pursued rigidly. Therefore, like it or not, given the current state of the world, judgment in monetary policy is a necessary fact of life.

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Question 6. Corporate Debt. Chairman Volcker has expressed concern about the rise in corporate debt. For example, in 1984 and 1985 nearly $80 billion of corporate equity was exchanged for debt. As a result, the corporate debt/equity ratio has risen sharply.

Some suggest the rising levels of corporate debt are making the economy far more vulnerable in the next economic slow-down.

Others suggest that more corporate debt is a good thing--that it keeps corporate managers on their toes since they must meet the interest payments.

Where do you stand on this issue. Is the rising level of corporate debt a threat to the economy, or is it a blessing in disguise?

Answer. Huge amounts of equity have been retired by a relatively small number of firms. While the added debt does in general act as a disciplinary force on corporate management, in some cases the resulting increases in leverage may leave firms vulnerable to a serious weakening of the economy or a sharp rise in interest rates. Given the credit problems we have already, such leveraging makes me uncomfortable, and I think that, in particular, the incentives for debt finance contained in our tax code need to be examined closely.

Question 7. Bank-Deregulation. There are some who argue that bank deregulation has run its full course and that banks should not be granted any new powers.

Others continue to argue that banks need new powers in the area of real estate, insurance, and securities if they are to compete with other financial services conglomerates.

What are your views--do you favor expanded powers for banks and bank holding companies or should we hold the line?

Answer. In concept, I favor expanded powers for banks. However, I believe steps in this direction should be taken in a cautious and orderly manner because the risks of such activities, especially when combined with traditional banking activities, are largely unknown. Caution is especially important today, given the strains on the banking system.

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Question 8. Merger of FDIC and FSLIC. There has been some talk about merging the FDIC and the FSLIC in order to strengthen the latter institution. According to studies by the Bank Board's staff, the potential losses from under water thrifts could exceed $15 billion while the FSLIC has less than $4 billion in un-encumbered reserves.

What are your views on this issue? Should we merge the two institutions, or should we try to keep them separate?

Answer. Merger of the FDIC and FSLIC insurance funds would, in principle, be appropriate if the depository institutions involved had to adhere to equivalent regulatory and supervisory standards, and particularly if their powers broadly coincided. While there has been considerable movement in this direction, there still are substantial differences in these areas between the classes of depository institutions. Until these conditions are met there are major doubts as to whether monies contributed by commercial banks and mutual savings banks should be made available to protect the depositors of savings and loan associations. In the interim the Congress should perhaps consider other means of bolstering the size of the FSLIC.

Question 9. Agricultural Credit. Congress has before it a number of proposals for easing the agricultural credit crisis. One idea is to extend the net worth certificate program provided to thrift institutions to agricultural banks. Another proposal is to allow agricultural banks to defer loan losses over a longer period of time rather than taking the entire hit when the loan is written down. Many banks have urged that agricultural banks be afforded the same relief Congress made available last year to the Farm Credit System.

How serious is the farm credit problem, and what proposals, if any, would you recommend for dealing with it?

Answer. Farm loan difficulties have been increasing for several years, and have been serious enough to cause the failure of scores of agricultural banks and to pose major problems for many other banks as well as other farm lenders.

In considering ways in which farm borrowers and lenders might be assisted, it is important to recognize the nature of their difficulties and their prospects for financial recovery. The farmers in financial stress are a minority, albeit a sizable one, most of whom borrowed heavily at a time when the outlook for farm income seemed very favorable. But the expected income growth did not materialize, and thus a growing number of farmers have been unable to service their debt. Nor can they sell their land to pay off their debt, because farm land prices have fallen.

Because prospects seem rather dim for improvement in the financial condition of heavily-indebted farmers over the next several years, I am somewhat skeptical of the advisability

of allowing lenders to prolong the period over which they recognize the impact of existing loan losses, or using technical accounting devices such as net worth certificates to disguise their financial condition. These strategies may be useful in coping with some well-defined cyclical difficulties which appear relatively certain to be resolved in the near-term, but the farm credit problem does not fit this mold. We must face the unfortunate fact that, in many cases, farm loan difficulties represent funds permanently lost. Under the circumstances, more fundamental actions aimed at recovery and revitalization in the rural community may be of greater help. Among the possibilities are programs to assist bankrupt farmers in re-entering farming, facilitating capital infusions into agricultural banks, and, for the long run, promoting rural economic development.

I do want to stress that, to a considerable degree, the credit problems in agriculture today had their roots in a basic macro-economic distortion, namely the inflation that gripped the economy as a whole in the 1970s. It was during that period, when expectations lost contact with fundamental economic realities, that so many of the financial commitments were made that are the source of the present dislocations. And in the long run, the key to avoiding a recurrence of the recent experience is to be found in the maintenance of price stability. I

have some concern that people will look to the tools of regulation and supervision for a long run solution; to be sure, regulation and supervision have a role to play in preventing excesses, but we must be careful not to hamstring our financial institutions in ways that in the end will make it unattractive for investors to supply them with capital and thus will reduce their ability to serve the rural community.

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Question 10. Delayed Funds. The House is about to pass legislation requiring banks to make checks deposited by consumers available in two or three business days. As you know, some banks restrict availability for ten days or even longer. Many consumers have complained about this practice.

What are your views on this issue. Do you support the passage of legislation such as the bill being considered by the House?

Answer. I believe that it is important for banks to deal fairly with their customers. Generally, competitive pressures will result in bank customers receiving equitable and reasonable treatment, but in some cases it may be necessary for the Federal government to assist the consumer by prohibiting certain bank practices that are inequitable or unfair to consumers.

Blanket hold policies under which all consumer checks are held for predetermined periods of time without regard to the creditworthiness of the drawer of the check or the depositor are detrimental to the consumer and are not necessary to protect the bank. While I have not had the benefit of review of all the information available to the House or the Board on this issue, to the extent that such practices persist steps should be taken to correct this inequity. Such steps might include disclosure requirements to allow consumers to choose among banks and therefore to correct these practices through competitive pressures. I do not believe that mandatory availability schedules, such as those contained in the House bill, are desirable to correct this problem.

Question 11. Credit Card Interest Rates. Consumer groups have charged that the rate of interest charged by banks on credit cards is way out of line with the bank's cost of funds. They point out that while all other interest rates have come down, credit card interest rates have stayed the same or gone up. I am told that some banks charge as much as 24 percent.

Senator D'Amato has introduced a bill to put a federal ceiling on credit card interest rates. Do you agree that credit card interest rates are too high, and if so, do you favor federal legislation to control them?

Answer. Over time, credit card interest rates are likely to be relatively sluggish, in part because administrative expenses are a major share of the cost of such accounts and these costs do not move in line with market interest rates.

With regard to the role of federal legislation, I agree with the position previously taken by the Federal Reserve Board that would leave any such decision to regulate rates to the states. Nonetheless, past experience has shown that usury ceilings--be they federal or state imposed--can have distorting effects on credit flows, channeling funds to alternate uses where yields are unconstrained and limiting credit to borrowers who in many cases may not have access to other sources of finance.

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Questions Submitted by Senator Dodd to Mr. Angell
Nomination Hearing -- January 23, 1986

Question 1. In yesterday's New York Times, Lester Thurow argued that our financial markets are so fragile today that we could once again see the financial panics of the 1920's and the great depression of the 1930's.

For example, he said that: "The loan portfolios of American banks include more than $500 billion in farm and third-world debt, where default is easily imagined. As oil prices fall, what were good oil loans are rapidly becoming bad ones. Major banks are sinking under the weight of falling real estate values. Mergers and leveraged buyouts lead to firms that can barely meet interest obligations in boom periods and that could not meet them in a recession."

How fragile do you think the financial system is?

What would you plan to do to alleviate the problems as a member of the Fed?

If you could control both monetary and fiscal policy, what would you do about these problems?

Answer. Looked at broadly, the financial system clearly is somewhat fragile now, more fragile than one would like, but not precarious. It seems quite unlikely to me that, with proper monetary and fiscal policies, we will experience a generalized financial crisis.

Many present financial problems--including difficulties related to the agricultural sector, the energy market, and third-world borrowers--can be traced to the inflationary binge of the 1970s and its subsequent unwinding; contributing to these problems have been large federal budget deficits that have placed upward pressures on real interest rates. Monetary policymakers can best contribute to a solution of these problems by pursuing a responsible monetary policy aimed at the achievement and maintenance of price level stability. Fiscal policy should be directed decisively towards balancing the federal budget. As the strong positive market reaction to the Gramm-Rudman-Hollings legislation has demonstrated, there is substantial scope for easing pressures on financial markets by reducing the deficit. Even with appropriate monetary and fiscal policies, it may take some time before present strains on our financial system are relieved.

Question 2. As you well know, the Congressional concern with huge budget deficits resulted in the Gramm-Rudman-Hollings legislation. To meet next year's target deficit of $144 billion, we will probably have to cut about $60 billion. I won't ask you whether we can do that without increasing revenues, because that is a question for us, but what I would like your opinion on is whether it would be better to reduce the deficit by $60 billion, if we had to raise some revenue to do it, or reduce it by some lesser amount--say, $40 billion- with only revenue cuts?

Answer. It is very important to get the federal deficit down. I believe it would be best to achieve that objective by lower spending, to the maximum extent possible, before considering tax increases that can distort incentives and reduce economic efficiency.

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Question 3. What do you think we should do to strengthen our deposit insurance funds?

Answer. Proposals to strengthen the deposit insurance funds deserve serious attention. Whatever is done should preserve the dual goals of protecting the small or unsophisticated depositor and of insulating banks and the payments mechanism from systemic risk. Reform proposals which hold some promise of success and which should be studied further include strengthened supervision and regulation, increased capital standards, risk-based capital standards based on the riskiness of nontraditional banking activities, some limits on insured deposit brokerage activities, and perhaps increased use of market discipline by, for example, increasing the risk exposure of large depositors.

Questions Submitted by Senator Dixon to Mr. Angell
Nomination Hearing -- January 23, 1986

Question 1. Do you favor restricting the amounts of preferred stock and mandatory convertible instruments includable in primary bank capital, as proposed by the Board of Governors in November of 1985?

Answer. In general I agree with the logic underlying the proposed restrictions. As indicated in my response to the next question, however, I believe that small, independently-owned banks and bank holding companies should be subject to fewer restrictions regarding the composition of capital than larger institutions because the sources of capital on which they can draw are more limited.

Question 2. Some small and independent [illegible] have contended that the proposal will eliminate, for them, a principle source of permanent equity and curtail the use of advantageous estate and tax planning tools. Do you believe the proposed regulatory limitations could have such an adverse effect or whether closely held companies could be exempt from its provisions?

Answer. I believe that it is important to foster an environment that is conducive to the ownership of small banks by individuals. Therefore, I would seriously question any regulatory restrictions that would undermine that objective or hinder the ability of small banks to access the limited sources of capital now available to them. But I understand the Federal Reserve has in place separate and more liberal capital standards for small bank holding companies that are designed to facilitate the independent ownership of small banks and that the proposed restrictions on preferred stock and mandatory convertible instruments would not apply to bank holding companies with assets of less than $150 million.

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Question 3. Does the proposed limitation on the components of bank capital improve the regulation of capital adequacy which is currently analyzed on a subjective, bank-by-bank basis?

Answer. The proposal should improve the regulation of capital because it will assure that a large proportion of the primary capital base will be in the form of common stockholders' equity--the kind of primary capital that provides the highest level of protection during periods of financial stress. In my view, the proposal will make the determination of capital adequacy less subjective. This is all to the good because I believe that all rules and regulations should be as clear, direct, and unambiguous as possible. Markets work best when the rules and regulations are understood by all participants.

Question 4. Should this Committee review the entire issue of the "control" of banks, considering issues such as what some argue are in effect cases where there is de facto control by non-voting security holders and holding company creditors?

Answer. The Bank Holding Company Act provides that a company may not acquire direct or indirect ownership of more than 5 percent of the voting shares of a bank, or otherwise establish effective control over a bank, without the prior approval of the Board of Governors. In order to provide greater guidance on the question of control, the Board issued a policy statement in 1982 setting forth a framework for evaluating whether the acquisition of non-voting securities of a banking organization is consistent with the control provisions of the Act. Among other things, the policy statement describes a number of provisions that would leave an organization's management free to conduct its banking business and, therefore, that would generally preclude a finding of de facto control. The statement also describes the type of provisions that would raise serious questions of control under the Act. The policy does not address the issue of control exercised by a holding company's creditors.

While I have not yet had an opportunity to study this matter in depth, upon first review the Board's policy statement appears to be a sensible approach to issues relating to the exercise of control. As a general rule, I am open to reconsidering supervisory and regulatory approaches if warranted by changing times or circumstances. Therefore, I would welcome the opportunity to cooperate with this Committee in reviewing issues relating to the exercise of control over banking organizations.

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The CHAIRMAN. Next we'd like to continue the hearing with the nomination by the President of Manuel Johnson to be a member of the Federal Reserve Board. We see in our midst the distinguished Senator from Virginia. Senator Warner, we would be happy to recognize you at this time.

STATEMENT OF SENATOR JOHN WARNER, U.S. SENATOR FROM THE STATE OF VIRGINIA

Senator WARNER. Mr. Chairman, I shall be very brief because brevity is in order. This is one of the more outstanding persons to come before the Senate in my judgment to fill this important position on the Board.

The President's nominee, Mr. Manuel Johnson, is accompanied today by his wife, Mary Johnson.

As the chairman knows, he's presently Assistant Secretary for Economic Policy at the Treasury. He's been at the Treasury since 1981 and prior thereto he was a professor of economics at George Mason University, one of Virginia's most distinguished educational institutions.

The full biography is before the committee. Mr. Chairman, knowing you and other members of the committee and their interest in the various aspects of the person's background, I thought I would select today to emphasize the unusual and diverse number of the recognitions that this nominee has achieved in his lifetime.

As a member of the U.S. Army he was a green beret, completed ranger training, qualified parachutist, jungle expert——

The CHAIRMAN. If I may stop you to say that I noticed his being a jungle expert, and that's very important here in Washington.

Senator WARNER. Mr. Chairman, I think you have a note of sincerity in those remarks because I know you and all the diverse things that you have done.

The CHAIRMAN. I have had jungle experience here in Washington but I came with none, so it was harder for me when I first got here.

Senator WARNER. He went on to achieve a degree with honors; Omicron Delta Epsilon, economics honor society; doctoral dissertation; Nuclear Regulatory Commission; Labor Economics Prize, best research paper in labor economics; honorary president, Troy State University; Alumnus of the Year in 1982, Troy State University; Honor Award for Outstanding Contributions to Public Policy, Florida State University; Secretary's Honor Award for contribution to first foreign-targeted securities issue, U.S. Treasury Department, and on and on goes this most distinguished biography.

I'm privileged to be here today to recommend to this committee this outstanding American public servant. I thank the chairman and members of the committee.

The CHAIRMAN. We appreciate your willingness to be here.

Dr. Johnson, I'm pleased to have you come before the committee and I welcome you to the committee today. You have been nominated to the Board of Governors of the Federal Reserve System to fill a full 14-year term that runs until January 31, 2000. It sounds like an awfully long time, but my experience is that it will rush by rather rapidly. It seems like I arrived yesterday and this is my 12th year.

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You have already had very extensive experience in economic policymaking. You currently serve as Assistant Secretary of the Treasury for Economic Policy. Prior to joining the Treasury Department in 1981, Dr. Johnson was a professor of economics at George Mason University in Virginia. He did graduate work at Florida State University. During his academic tenure he was a prolific publisher on a wide range of economic issues in a wide variety of professional journals. As Assistant Secretary of the Treasury for Economic Policy, Dr. Johnson has advised the Treasury Secretary on all monetary affairs, has developed first-hand experience with the operation of Federal Government debt financing and its relationship with monetary policy.

Dr. Johnson has also been involved at the Treasury in the development of administration policies on the financial sector of regulation and supervision, international lending and exchange rate.

I would also add that Dr. Johnson certainly fits what we have been trying to do, as I mentioned earlier in the first hearing, being from the proper geographical area.

Dr. Johnson, before you testify, could I have you stand and be sworn.

[Whereupon, the witness was duly sworn.]

The CHAIRMAN. Senator Hecht, do you have any comments you wish to make before we start?

Senator HECHT. No; thank you, Mr. Chairman.

The CHAIRMAN. Senator Riegle, any opening comments?

Senator RIEGLE. No, Mr. Chairman.

The CHAIRMAN. Please proceed, Dr. Johnson.

STATEMENT OF DR. MANUEL H. JOHNSON, JR., ASSISTANT SECRETARY OF THE TREASURY FOR ECONOMIC POLICY

Dr. JOHNSON. Thank you, Mr. Chairman.

I don't have a prepared statement to submit, but I would like to make a brief remark before I answer any questions.

First, it's both a pleasure and an honor for me to appear before this distinguished committee for consideration as a Governor of the Federal Reserve System and, if confirmed, I will try my very best to pursue monetary policies that result in sustained economic growth and employment consistent with stable prices.

This is obviously a difficult task in such a complex and interdependent world, and monetary policy alone cannot guarantee such an outcome. I don't profess to have all the solutions to this economic puzzle, therefore I look forward to working with the members of this committee and other Members of Congress to try and resolve any problems that may arise in the future.

Thank you.

The CHAIRMAN. Dr. Johnson, do you agree to appear before this committee and any other duly constituted committees of the Congress as requested?

Dr. JOHNSON. Yes, sir; I do.

The CHAIRMAN. And do you agree to not only avoid any actual conflict of interest in your service on the Board but even the appearance of conflicts of interest?

Dr. JOHNSON. Yes, Mr. Chairman.

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The CHAIRMAN. Dr. Johnson, my first question to you would be the same as to Dr. Angell. That is that I personally feel very strongly about the independence of the Federal Reserve Board.

Over the years, we have had a large number of suggestions about how the Board should be reconstituted from, on the one hand, those who proposed bills that would make the term of the Chairman of the Federal Reserve concurrent with that of the President so the President could pick his man and put him in there for his term. We've had suggestions that going beyond the geographical requirements of the law that we have a farmer, a small businessman, a Member of Congress, the Secretary of the Treasury—all sorts of different categories, and that we divide it up on the basis of, well, this will be a seat for small business and this will be a seat for farmers and so on.

We have also had proposals since I have been here to actually pass a law to set the monetary targets by Congress. I would hate to think what would have happened back in 1975 or 1976 when that was proposed if we had had Congress arbitrarily setting inflexible targets, coupled with the irresponsible fiscal policy we've had in Congress for so many years.

I give that same background to you that I did to Dr. Angell because I think that the Fed must remain independent and members of the Board should express their views. If they agree with an administration or a Congress, fine. But if they don't, they should have the willingness to state that regardless of what the political consequences may be. I think this has been one of the real benefits of the Federal Reserve System.

So I certainly have outlined to you how I feel. I'd like to know how you feel about being a member of the Federal Reserve Board of Governors. You were appointed by President Reagan. Do you have the independence to steer your course regardless of your background in this administration and Treasury?

VIEWS ON THE CENTRAL BANK

Dr. JOHNSON. Yes, Mr. Chairman. First, I totally agree with your opinion about the independence of the Federal Reserve Board. As an economist who's studied the actions of central banks throughout history and looked at their performance, I think that from an economic perspective the major factor that separates the developed countries with stable economies and relatively lower inflation rates and better economic performance from some of the developing countries or those who have had highly unstable economies, both in terms of hyperinflations and roller coaster-type changes in real output, has been the independence of the central bank and I think that you're absolutely right, insulating the actions and decisions of the central bank from political pressures I think is extremely important and it allows the tough decisions necessary to maintain stability in prices but at the same time keeping a watchful eye on the real growth performance of the economy.

I think that if you really study the record you will find that those banks that are highly subordinated to the political process have relatively unstable economies and have experienced extremely rapid inflation rates at various points in time. I don't need to

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cite countries who still experience that today. They're all fairly obvious. But I do feel very strongly about the independence of the Fed.

Now there are some areas in which I think improvements can be made that I think are important. I do think that the central bank should be forthcoming on providing information to the public and the financial markets about its policy actions, and it's well known that the Treasury has supported the idea of coterminus terms between the Chairman and the President but very similar to what Chairman Volcker has voiced support for himself, coterminus terms with a 1-year lag.

I would also possibly support earlier provision of the FOMC minutes that gave more accurate and timely information about policy changes to the financial markets, the public, the administration, and Congress. But it's absolutely imperative that the independence of the central bank be maintained.

The CHAIRMAN. Well, I would agree with you on earlier information. Chairman Volcker and I have talked about that in this forum over a number of years and his usual answer is, "Well, we don't like to signal this or that"; and yet, the game playing that goes on out there waiting for those figures—I don't understand the other side of it. When we're trying to put more certainty into a marketplace, information, rather than guessing about what the information might be, I think would provide some more stability. So I'm glad you feel that way.

In the Treasury Department you conducted studies which concluded that higher Federal deficits cannot always be expected to push up interest rates and drive up the value of the dollar. A lot of critics of your studies say that your conclusions are incompatible with common sense.

How would you respond to those critics of your reports?

Dr. JOHNSON. Well, Mr. Chairman, it's true that during my tenure at Treasury we did perform a number of studies, one in particular that was published which concluded that you couldn't statistically verify a systematic relationship between Federal budget deficits and interest rates.

RESULTS OF TREASURY'S STUDY

However, there were a number of qualifications and the report was very technical and went through quite a bit of theoretical reasoning and empirical research. It pointed out that if in fact you were able to hold all the other economic variables in the economy constant and realize a large Federal budget deficit, that indeed you would expect interest rates to rise. It is commonsensical to think that if you have a fixed pool of private savings and the Federal Government is borrowing large amounts of that and draining that pool of private savings that it's going to leave less available in the private sector for private participants seeking credit for their investment purposes.

It's only natural to reason that way and expect interest rates to rise as a result and, indeed, if nothing else in the world were to change, that in fact is what would happen. I think the reports and the studies that we've done at Treasury point out that theoretically

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under those conditions interest rates would be expected to rise. However, in the real world, a number of things happen and our statistical studies have tried to isolate the effects of deficits from interest rates given all the changes that have taken place in the world and are not able to pick up this systematic relationship that commonsensical reasoning comes up with.

That doesn't mean that deficits don't put some pressure on the interest rate. All it means is that there are other things changing at the same time that we realize large deficits. For example, because we live in an open economy we have seen large capital inflows in the United States from abroad which has supplemented domestic savings. So at the same time the Federal Government may be taking a larger supply of domestic savings, there are also additional capital flows into the U.S. economy from abroad which offset that effect.

It's also true that if you were to increase the deficit by cutting taxes where the marginal tax rate was lowered substantially on income earned from savings, you would expect a savings response as a result of those lower taxes on savings. Therefore, at the same time that Government borrowing would reduce savings in the private sector, it's also true that savings would increase as a result of the incentive measures of the tax changes. So, the net effect is not totally clear.

Even though Government borrows large amounts, it's quite possible that people don't use only their private savings to purchase Federal Government bonds. In fact, it's quite possible that private purchasers of Federal securities cut back partially on their consumption in order to purchase Federal Government securities. So it's not necessarily true that financing the Government debt comes entirely out of private savings.

All of these things complicate the issue and make it fairly ambiguous when you try to empirically measure the relationship between the deficit and interest rates. I think the point that we tried to make with that study was that if the deficit per se is not systematically related to the interest rate we should be careful in trying to cut the deficit in a way that does not clearly improve net savings and the economy.

For instance, if we raise taxes to solve the deficit we extract private savings from individuals just as if the Government continued to borrow to finance Government spending.

So, the point we tried to make was that the only clearly unambiguous way to cut the deficit would be to cut the rate of growth of Federal spending because that would eliminate the additional financing requirements that put pressure on raising taxes, that put pressure on further Federal borrowing, or put pressure on the central bank to monetize the debt.

The CHAIRMAN. Well, for those of us who are not trained economists and getting away from all the technicalities of the study then, and I understand how you've explained it, but getting back to the commonsense quote of one of your critics, common sense does tell us that deficits, however you try to solve them—obviously there are some differences—but deficits are an important factor in interest rates.

Dr. JOHNSON. Absolutely, Mr. Chairman.

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The CHAIRMAN. So you're not saying they're not important?

Dr. JOHNSON. We are not saying that they are not an important factor, by any means. We are saying they are very important. There are a lot of other things going on in the world, too, that we also should concern ourselves with and that makes it important how we deal with the deficit to avoid any other side effects as a result of dealing with the problem.

The CHAIRMAN. Senator Proxmire.

Senator PROXMIRE. Thank you, Mr. Chairman.

Dr. Johnson, I want to get on the same subject the chairman was just asking about in a little different way. You have a deserved reputation as an extraordinarily brilliant young man and you're going to be on the Board of Governors of the Federal Reserve Board for a long, long time, into the next century, the year 2000. Most of us will be long gone and 6 feet under by the time——

The CHAIRMAN. Speak for yourself.

Senator PROXMIRE. Well, we have a very youthful chairman here. He'll be around, if he's not out in space somewhere.

In March 1984, the Treasury Department released a study which concluded: "that high-Federal deficits have had at most a negligible effect in raising real interest rates."

You were the principal author of that study. In testifying on that issue before the Joint Economic Committee in October 1983, you suggested one possible explanation for this result. Here's what you said and I quote.

> One framework of analysis notes that when taxes are cut Government borrowing is increased by an equal amount. Some, perhaps all, of the tax cut will be spent on new Government bonds. The total amount of the tax cut will be used to purchase new bonds if the taxpayer-bondbuyer perceives that the bond interest he receives will be used to pay the future tax required to service the Government debt and that the return of the principal of the bond will be used to pay the future tax required to retire the bond.

It seems to me, Mr. Johnson, that the notion that people deliberately increase their purchases of Government bonds because they anticipate a future tax increase seems very, very far fetched. In fact, it seems to me to be almost bizarre.

Here's what the CBO said about that theory:

> Most economists consider this theoretical view excessively abstract and the evidence in its support unconvincing.

What are your views on this? Do you agree with the CBO assessment or do you seriously believe that people are buying more Government bonds because they anticipate future tax increases?

Dr. JOHNSON. Well, if I remember right, when I read that in my statement, you responded in the JEC by saying that that was one of the most complicated explanations you had ever heard and you can't imagine any member of a household going out and increasing their savings because they expect future tax increases.

Senator PROXMIRE. You've got a much better memory than I have. I didn't remember I even said that.

Dr. JOHNSON. You made a very interesting comment. I have to admit that that is an extremely cumbersome theoretical explanation. What I was trying to say there was that one explanation of how the deficit does not totally preempt private saving is that when a deficit is incurred, people expect some future action by

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Government to offset that deficit at some point in the future, whether it be by taxes, whether it be by excessive money growth, or any other means, there's going to be some harm done to their income in the future so that they choose to save more in the current period—to sort of put aside savings for a rainy day—to avoid this future outcome or to pad their savings to offset this future outcome.

Now it sounds abstract to me too, and I'll admit that, in fact, I think this is strained reasoning to expect when a deficit is incurred from a tax cut or any other means that people say, "Oh, well, there's going to be a future cost to that and I'm going to start saving today to make sure that I have that savings when the Government decides to tax it away in the future."

However, researchers in the academic profession who have tried to reject this theoretical notion by doing statistical work have not been able to totally reject this. I'm not sure that the theoretical reasoning is why they haven't been able to reject it.

Senator PROXMIRE. But the practical development since the big tax cut in 1981 is that savings have dropped sharply. Now, as you know, there have been months when they have been below 2 percent, an astonishing low figure. They seem to be going in the opposite direction.

Dr. JOHNSON. Well, Senator, it's absolutely true that personal savings as a percent of personal income is down and that is a reason for some concern. However, total savings in the economy is up substantially, and by total savings I mean net foreign capital inflows as well as business saving from both depreciation and retained earnings and the surpluses run by State and local governments. All of these factors added up together, even when you sort out the Federal Government deficit, lead to fairly large levels of total saving. It is true that personal savings is low.

Senator PROXMIRE. I challenge you on that figure that there are large levels of total savings. The figures that I've seen is that in relationship to income and in relationship to gross national product and so forth, the savings have not increased over the last several years.

GROSS PRIVATE SAVINGS UP 19 PERCENT

Dr. JOHNSON. Well, I think if you will look at gross private saving you will find that it is at very high levels. I think as high as 19 percent.

Senator PROXMIRE. Well, everything is at a high level now of course because of the inflation and so forth.

Dr. JOHNSON. Well, I should say, as a percent of the GNP, total gross saving I think is running around 19 percent.

Senator PROXMIRE. Let me follow up by asking you this. If people really purchased more Government bonds in anticipation of a future tax increase, then according to the rational expectations theory of economic behavior the Reagan economic program has no credibility with the public. That is, a rational person does not believe it is possible to vastly increase defense spending, cut taxes, and balance the budget all at the same time.

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If we accept your theory about deficits and interest rates, wouldn't we also have to acknowledge that President Reagan's economic policies, which you helped to design, are fundamentally irrational?

Dr. JOHNSON. Well, I'm sorry.

Senator PROXMIRE. I don't expect you to answer yes to that.

Dr. JOHNSON. No; I certainly can't agree with that and I think they are highly rational. I think that when we put the economic program together back before the beginning of the administration and even the first stages of the administration, there was never any intention to run a deficit by any means. As a matter of fact, no one is comfortable with the deficit, even though some of the research conducted at Treasury doesn't find a systematic relationship between deficits and interest rates doesn't mean that we are pleased about the deficit. As I said from the beginning, the deficit does preempt private savings and makes less available and obviously if you cut the Federal deficit and cut back on the amount of Federal borrowing, that would mean more capital available for private expansion and investment.

So I certainly would like to reduce it. I think it's very important now. When we started this program we proposed maintaining budget balance at the same time that we cut tax rates by substantially reducing the rate of growth of Federal spending. We have continued to make proposals to try and deal with the deficit problem on the spending side, not always with success, but we continue to insist that we deal with the deficit primarily by those means and we think that this will add to the economic health of the country and sustain economic expansion.

We clearly want to deal with the deficit, but we think it's important how we do it.

Senator PROXMIRE. I read with considerable interest your speech you made on our trade problem in July in which you criticize, "those who emphasize the U.S. budget deficits have pushed up interest rates and therefore caused the dollar to appreciate." You said then you found it very curious that people could believe that large budget deficits would reduce the world's strongest currency. It was your view, you stated, that the strong dollar results primarily from improvement of the productive potential of the U.S. economy brought on by the 1981 Reagan tax cuts.

Now this puts you at odds with most other economists who have looked at this issue, including the former Chairman of the Council of Economic Advisers and President's former Special Trade Representative. Martin Feldstein said, for example, in an article in the summer 1985 edition of Foreign Affairs, and I quote:

> Some commentators have tried to explain the sustained rise in the value of the dollar by pointing to dynamism and profitability of the American economy. I believe that these factors have had relatively little direct effect on the value of the dollar. The vast bulk of foreign funds coming into the United States have come as bank deposits or as purchases of fixed-income securities and have not been investment in corporate stock or direct investment in American business. Thus, the profitability and dynamism of the American economy have attracted foreign funds primarily by contributing to the rise of U.S. real interest rates.

What is your reaction to that?

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Dr. JOHNSON. Well, I would disagree with that. I stand by what I said earlier. I think that the primary reason why we have attracted capital into the United States is not because the deficit has pushed up interest rates higher relative to other countries. If you look, as a matter of fact, at relative interest rates between the United States and our trading partners, you will not find them especially high in a relative sense or that they have dramatically diverged from each other over the last several years.

Senator PROXMIRE. If it's a matter of increased productivity, why don't they invest in American corporations and so forth and buy stock which would reflect that kind of efficiency? They haven't done that.

FOREIGN FUNDS HAVE HELPED CORPORATE EXPANSION

Dr. JOHNSON. Well, in fact, through the financial intermediation process, they do, even though they may be buying bank CD's or other types of paper-type securities or savings instruments. The financial intermediation process obviously invests these funds directly by lending those funds that were put in financial institutions to U.S. corporations or other firms who are purchasing capital assets and in building plants and machinery and I think a good example of what's happened is just to look at the data on gross private investment since 1982. Gross private investment, domestic investment, has grown at over two times the rate of GNP growth, which is very extraordinary for any postwar expansion period.

So I think that the capital has been attracted into the United States for a couple of reasons. I think clearly capital wouldn't flow to the United States—I don't think investors would put their money into the United States because of a large deficit in the United States. I would think that people would consider the deficit to be somewhat of a risk to their investment. So I think that if people are choosing to invest in the United States by moving their capital here, it's for other reasons. The deficit I think adds to the riskiness of the investment and it must mean that adjusted for this risk there are other reasons.

Senator PROXMIRE. My time is up, but it seems to me the obvious reason is because they get relatively higher interest rates given the fact that they can buy U.S. Treasury securities and other similar securities with no risk at all.

Dr. JOHNSON. But they can get similar interest rates in other countries, too.

Senator PROXMIRE. Not without any risk.

Dr. JOHNSON. Well, that's a good point. I think that one of the major reasons why the dollar is strong and capital has flowed in has been the dramatically higher risk involved in investing in Third World countries because of the debt problems that they have faced and, therefore, commercial banks, money center banks, have pulled back their lending to these countries and left funds in the United States.

So certainly the higher risk abroad in Third World countries because of debt problems and other reasons have caused a lot of the capital to flow here. But that means on a risk-adjusted basis it must be that the returns are higher in the United States. I agree

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with that. I think once you adjust for the lower tax rates that have been introduced at the Federal level, plus the lower risk involved in investing in the United States versus debtor nations and other countries that are growing at a slower rate, you will find that in fact the rate of return on investment is higher in the United States.

Senator PROXMIRE. Thank you. My time is up.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

You've got a birthday coming up here on February 10 and so it's significant I think that you're here for such an important job at a key time in our Nation's history and at a relatively tender age, and I can appreciate how that feels, having come to the Congress myself at a rather young age.

But I guess I want to just reflect on that for a minute before getting into the questions and I gather you were in the room for the previous discussion with Dr. Angell?

Dr. JOHNSON. No, sir; I was not.

Senator RIEGLE. Because I want to cover some of the same things and I just wanted to know if you heard that discussion or not. You are about to be 37 years old and is it your intention to serve the full 14-year term?

Dr. JOHNSON. Yes, sir.

Senator RIEGLE. I think that coming in now into this job in my view is as important, say, as being appointed to the Supreme Court. I mean, that's a lifetime appointment and that also comes at a time when there are a lot of very profound questions before the Court, and I make the analogy because I think that what is happening with respect to the economic system and the profound economic changes that are underway and we will likely continue the trend lines that we say that in many cases are accelerating, what happens out over the next 14 years with respect to financial management decisions in this country, private and public together, I think will really tell the story as to where America is 14 years from now. Are we still a preeminent world leader? Do we have the capacity to carry out our very expensive defense obligations? Are we able to educate our people? Can we pay our medical bills? Can we modernize and remain at the state-of-the-art level with respect to world competition, particularly when we see what's been developing there and where we've really been I think not doing so well relative to others, which the Presidential Commission on Productivity laid out very starkly.

So it seems to me that the decisions that are going to be made—and you may be part of them more than anybody else that's on the Board. One doesn't foresee probably most of the other members necessarily serving that long and it's your intention, with good health and so forth, to serve for that length of time, and well beyond this administration, presumably into the next two administrations, whoever they happen to be headed by.

So I guess what I want to say to you—and as I've gone through your list of accomplishments and you're obviously a prodigious worker and I really salute you for that kind of effort, and you've written a number of things and you've expressed a lot of opinions on a lot of things and yet I guess what I'm concerned about is that

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things are changing so fast that I suspect that even some of the articles that you may have written 5, 10 years ago, even 2 or 3 years ago, you might not write the same way today because things have changed, your thinking has changed, and so forth and so on.

I guess what I would like to just say—and I'd be happy to have you respond in any way you like, but my hope for you would be that you could give a distinguished period of service and could be able to help sort of guide policy and guide the country through some new questions, some very difficult choices, where I for one think that a lot of the economics textbooks that are several years old aren't particularly relevant to us as road maps as to where we go from here. There are some basic underlying principles about the stable dollar and economic growth and open markets and so forth which are sort of bedrock ideas, but the question of how you manage this economy publicly and privately in the midst of the changing world economy it seems to me is a new puzzle and a very complex one.

So I would hope that you would be the kind of person that would be able to give the kind of fresh thinking and intellectual leadership to the role that you would play that might have you in fact even taking different views 3 years from now from something you thought 3 years ago simply because circumstances have changed and that you're the kind of person that's capable of not being so locked and so rigid that you can't make those changes in your own thinking and help the country both understand and respond to some of these profound changing economic realities. That's my hope for you and I don't know whether you want to comment on that at all or not.

Dr. JOHNSON. Sure, I would like to. I like to think that I keep an open mind on issues. I have convictions about things that I've studied very carefully, but I am also an empiricist so that over time, if the facts that I see don't fit the ideas that I have and I can't reconcile them in my mind, I'm certainly willing to rethink the problem and I certainly hope that I'm able to evolve with events as they occur if in fact the information that develops in the future doesn't fit the theories or views that I have. I'm not the kind of person that would continue to make claims about views that I have if in fact there is no supporting evidence whatsoever.

Senator RIEGLE. Do you consider yourself a supply-sider?

Dr. JOHNSON. Well, I wish I could say absolutely what that means today. I'm not sure. There are a number of different definitions that I've seen so I'm not sure that I fit into every definition of what a supply-sider is. The way I have always interpreted it is that I do generally feel that free markets lead to the most efficient outcomes and I support free-market-related types of policies.

But it doesn't necessarily mean that I think that tax cuts will pay for themselves overnight. So in a free market sense, I am a supply-sider.

Senator RIEGLE. Do you believe in the Laffer curve?

Dr. JOHNSON. Well, I think, first of all, there are different truths to a Laffer curve. I think for the top income tax brackets that get very high, there's a good bit of evidence to show that cutting the top capital gains rate or the top income tax rate may yield you more revenues because you would have people in such high tax

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brackets that they would pursue heavy sheltering in their income, but I think that you will find that the evidence suggests that a general reduction in taxes given the current U.S. tax structure doesn't lead to a full recovery of revenue and that you have to make up the difference in some other way.

Now eventually, as the income base improves over the long run, it may be possible to produce enough GNP to raise the tax base to higher levels, but I've never been able to find solid empirical evidence that across-the-board tax cuts pay for themselves in the short term.

Senator RIEGLE. Now I want to move into the trade question with you and I talked about this with Dr. Angell and because you were not present I'll say some of the things again that you were not able to hear.

I don't know if you saw the story on the front page of the New York Times today. The headline reads, "U.S. Economy Grew at a Slow 2.4 Percent Rate in the Final Quarter," which was a fairly substantial downward revision from what the estimates had been. But then the subheadline says, "Trade gap cited by analysts, 3-year GNP rise 2.3 percent worse since 1982" and then the article goes on in that vein.

I wonder, if I may, just show you a couple of charts that are derivatives of work of President Reagan's Commission on Productivity, and you may be familiar with these charts, but I just want to use them as the point of reference for a discussion I'm going to have with you on that issue.

I'm just going to cover two of them right now. One looks at our merchandise trade deficit over a period of time just to help illustrate in a more vivid way how fundamentally this has changed and how we've sort of gotten ourselves on an exploding curve of deficits, and we're going to run close to $150 billion this year based on the evidence I've seen, even on the change in currency values, I'm not convinced based on what I've seen now that we're going to get a miraculous change next year based on that. I think we're likely to run about the same way. As I watch the automobile thing, for example, I think we're going to get a lot more import penetration this year from Korea and other things which will help drive this in the same direction.

$500 BILLION DEBT BY 1990

In any event, we were making pretty good progress and then a problem developed but it's broken out in a very extreme way. But if you think of this as the income statement and balance sheet looking like this, and I'm asking you to think about this if you can from your own professional background and training. As you know, we've been in a creditor nation status since 1914 until just a few months ago when we crossed the line and became a debtor nation, but we're becoming a debtor nation at a very fast rate. The head of the New York Federal Reserve Bank has estimated officially now that by 1990, as this builds up, we become the leading debtor nation in the world. It looks like in about 6 or 7 months from now that will occur and we will surpass Brazil, Mexico, Poland, and other countries. But that by 1990, they're estimating a net debtor

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status for the United States of maybe a half a trillion dollars, $500 billion up to $1 trillion. That's a brandnew development. It's obviously a fundamental change from what the historic trends have been and it's very difficult to know precisely what that means. I'm trying to understand what it means and I'm sure you are, too.

And the reason that I show you those two is because when we talk about, in response to Senator Proxmire's questions—when we talk about capital flows and net capital inflows and so forth, and having studied economics myself, I'm trying to understand the difference between money and capital which is in our possession which we've earned in this country and which we spend for a foreign product, be it a car, or video recorder, or computer, or whatever it is, and we exchange the money, our capital, savings, which are in a sense not as large as we'd like them to be, and we get a durable good whatever it is and it comes over here and it has a useful life and it ends and it's gone, but we've transferred dollar wealth out and we've gotten a physical good in return and, of course, that's basically what underlies this pattern.

Now when the foreigner who sold us the good, whether it's Japan or whoever it is, they take the dollars they've exchanged the goods, now they can lend us back the money and they're doing a lot of that. Of course, they don't have to do it and if we ever get to a point where we desperately need the capital, then we might have to pay a lot more for it than we might want to pay for it simply because we've got to have it and they've got it and we haven't. But it starts out being our money, it becomes their money, it comes back if they loan it to us. Of course, they can invest it here too, but as Senator Proxmire points out, they have invested far less in manufacturing assets or physical assets than they have in debt instruments. So we owe that money.

And I must tell you that I am getting alarmed about the degree to which we owe that money and as that burden rises and if we get out to 1990 and we're a net debtor nation to the level that the New York Federal Reserve Bank anticipates and we've got that claim in terms of interest payments to pay that foreign debt, presuming they are willing to leave it here, because they're certainly not obligated to—they can pull that money out, they can sell the instruments or when they mature they don't have to roll them over, they can put the money somewhere else. So I must tell you I've got a very uneasy feeling about getting hooked on both this degree of foreign lending which we have to rely on, No. 1, and whether or not it's going to be there when we need it and what price we're going to have to pay for it, but I'm just as alarmed about the degree of our future national income that's going to be pledged to service that debt held by others coming off an adverse trade relationship that seems to now have established itself in a very adverse way with no signs of improving. In fact, it's staying where it is if not worsening. In fact, I think I could make a pretty convincing case that it will not be materially better in the next year. You might argue, but I think I can make that case.

So my question to you is: What does this mean in your mind? If we find ourselves in 1990, if these trend lines continue and if we're a net debtor nation to the tune of half a trillion dollars by 1990, what are the implications of this? I mean, you might argue that

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we're not going to get there and if you want to say that, fine; but I'm saying if in fact we should get there, what are the financial implications of that and is that an alarming prospect and is it something that we should try to forestall?

Dr. JOHNSON. First, Senator, I think it's very important in assessing the outcome of becoming a debtor nation how the debt was incurred and for what purpose. You have explained some of what it's going for and you're accurate in some of your description.

DEBTOR NATION FOR 200 YEARS

I think one thing you have to remember is that being a debtor nation is not necessarily bad. It depends on what you do with the borrowed funds. For about 200 years before the time we became a country until the turn of this last century, we were a debtor country and the reason why this didn't destabilize us economically was because the money that we were borrowing was used for developing our private economy, financing our rising capital stock. The amount of borrowing that was done and the amount of foreign investment in the United States went toward fundamental capital formation in general.

Senator RIEGLE. Let me just say parenthetically at that point, we had very little role externally in the world. We were basically an insular country. We certainly weren't carrying anything like the multibillion-dollar defense obligations for the world that we do today. So I think it's important to note that we were very much an insular developing country at that time.

Dr. JOHNSON. You're right. But the principle still holds that if in fact the borrowing that you do from abroad is used to invest in a capital asset that has a rate of return on it that produces income that is able to service both the principal and interest of that debt and return of profit, then in fact the debt is self-liquidating. In other words, even though you may continue to build debt, as long as it's income generating debt that creates an earnings stream like a capital asset, you will be able to service the debt.

Senator RIEGLE. But where does the earnings stream go? Who gets the earnings?

Dr. JOHNSON. Well, if it's invested in expanding the capital stock, then entrepreneurs, capitalists, who in fact earn profits off of the capital investments that they make are able to pay back the lender and earn a profit. Of course, that's part of our system. I mean, that's how we create wealth to some extent.

And I think that that is a difference between the debt that we incur today and the debt in the Latin American countries. Now I'm not saying they are totally different. To the extent that public borrowing consumes a lot of this capital and doesn't add to the capital stock and does not generate any future income flow, we have a problem.

Senator RIEGLE. Can we manage a $500 billion net debtor status in 1990 handily and is that something that we don't have to worry about getting into, or is that something that we ought to try to avoid?

Dr. JOHNSON. Well, principally, if in fact, as I said, the debt is incurred for reasons that generate rates of return that exceed the

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debt—and that would be the case for any capital investment that has a positive rate of return—then, in fact, this can theoretically go on indefinitely. However, I am not suggesting that is in fact what's happening. That's partially what's going on because we've seen an investment boom in this country.

However, to the extent that public borrowing is the result of the capital inflow and it's being consumed in a way that does not generate any increase in the future capital stock or generate income that will help retire the debt, then you have a problem.

Senator RIEGLE. Well, that's part of it. I mean, part of it is going into financing the deficit.

Dr. JOHNSON. So I'm saying, partially we have a problem that we need to deal with. But in fact, if you take the Brazils and the Argentinas and the countries who cannot service their external debt, if you look at those situations, almost the entirety of the external debt they have created for themselves has been the result of borrowing to invest in state projects or other types of projects that have generated no future income, and so they cannot service the debt because the borrowing that they undertook does not generate income.

ENORMOUS WORLD LEADERSHIP BURDEN

Senator RIEGLE. Let me tell you my concern with that analysis and I'm following what you're saying. That is, it seems to me that I think distant historical citations in the past are not terribly relevant to now. I think we're in a world economy. I think we've got an enormous world leadership burden that we've taken on for ourselves that's very expensive to handle and so forth. And I don't see that changing.

It seems to me that if we get out into 1990 and we're a debtor nation to the extent of a half a trillion dollars or more and we've got that debt burden to service periodically, we've got our internal debt burden to service, we've doubled the national debt in 5 years, certainly not an insignificant item. It's a very big item. The fastest growing item in the Federal budget is interest on the national debt and that alarms me enormously.

Dr. JOHNSON. Sure.

Senator RIEGLE. And what I'm concerned about is what you think of in a finance course as the lean-year test. You know, if the economy is rolling along and you've got the income and you can sort of meet your creditors' payments and so forth, that's one thing. If all of a sudden things become quite adverse economically, your income drops substantially and suddenly your Federal fiscal deficit widens out because maybe unemployment has gone up, whatever the set of reasons, to some high level, double digit level. And all of a sudden you find that you've got an enormous lean-year debt-service burden to have to meet and you've got to pay it because you owe it to foreigners and to the extent that payments are due I expect that they are going to want to get their money, just like we're trying to squeeze our money out of people today that we've loaned money to.

But I guess I'm surprised that you don't seem to express a sense of concern about working into that posture. Now if that isn't a

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problem at a $500 billion debtor nation status 4 years from now, would it be if we were at a $1 trillion level or a $1½ trillion level? I mean, is there any outer limit here that we have to worry about or not? If so, where is it?

Dr. JOHNSON. Absolutely. I can't give you a number and a time.

Senator RIEGLE. Give me a range. Give me a sense of your thinking.

Dr. JOHNSON. What I can say is, as I said before, if the reason for the growth in the debt is borrowing that is for pure consumption purposes, our Federal borrowing does not make any kind of infrastructure improvements or anything that increases future GNP, then you've got a problem. Now I don't know when the time bomb actually explodes in a situation like that. If you take a theoretical case where you're borrowing constantly and not generating any future income as a result of that, I would say very quickly you're going to have a serious problem. If you generate income but it doesn't fully service the debt, then it's going to take longer for you to have a problem.

Senator RIEGLE. Doesn't that put you in a bind if it's a proprietary investment, if it's a foreign company coming in and making an investment in the United States and they withdraw the profits—in other words, the profits are earned but the profits are taken out of the country because profits belong to the foreign investor—they don't really accrue to this country.

Dr. JOHNSON. They do partially. They take the profits from the capital investment to some extent, but they also improve labor productivity and hire American workers and they make wage payments on the basis of that. So part of the investment ends up improving domestic income as American workers earn more. So I'm saying, to some extent, it benefits the domestic economy even if they take the profits out of the country because they have to use that capital and they have to pay labor to actually perform the production function with the capital.

Senator RIEGLE. My time is up for this round, but wouldn't we be better off if we could keep and retain the ownership of the capital ourselves, the $500 billion, if we're at that point in 1990? Wouldn't we be better off as a nation, other things equal, if that capital continued to be our capital rather than money that's left this country and became some other nation's capital?

Dr. JOHNSON. Well, I think having the capital invested in the United States is beneficial.

Senator RIEGLE. The ownership of the capital you don't think is critical?

Dr. JOHNSON. Not necessarily, as long as it's reinvested domestically. If it goes out and it's permanently withdrawn and doesn't come back, then you have the wage payments and the things that benefit the American workers.

Senator RIEGLE. But you can shut a plant down overnight.

The CHAIRMAN. Gentlemen, excuse me. I've just got to interrupt you as a courtesy to Senator Proxmire.

BAKER'S THREE POINT PLAN

Senator PROXMIRE. I'll take as brief a time as I can.

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Dr. Johnson, in October at the IMF-World Bank meeting in Seoul, Secretary Baker announced a new initiative to deal with the international debt problem. One key element of the Baker three-point plan is to have the commercial banks put $20 billion more in new money into the debtor countries over the next 3 years. I know that some banks are complaining that the recent emphasis by bank regulators on increasing the capital levels of our banks will make it more difficult for them to come up with the new money for the debtor nations. Still others complain that the bank regulators are being too strict in administering the special reserves provision. Those reserves, as you know, must be established by a charge against income and they are not considered capital by the regulatory agencies.

I've heard reports that some high-ranking Treasury officials have said there would be a sympathetic review of such complaints by the relevant regulatory authorities in order to encourage new lending to debtor countries who cooperate in carrying out the Baker plan.

So my question is this. If confirmed, will you support efforts by the bank regulators to have the banks increase their overall capital levels and their special reserves against questionable foreign assets despite complaints by banks that such actions make it more difficult for them to put more money into debtor nations?

Dr. JOHNSON. First, I do support the notion of reserving against troublesome loans or bad loans and I certainly would support reserve capital in order to offset bad loans. As a matter of fact, I support the Fed's recent findings for some sort of risk-based capital requirements.

Senator PROXMIRE. So you favor a higher capital requirements in spite of——

Dr. JOHNSON. I think that you should be required to hold higher levels of capital reserves the more risky the investments that you undertake.

Senator PROXMIRE. I appreciate that. I agree with you.

Second, as a followup to the question I just asked, there was an article in the December 23 issue of Fortune magazine entitled "Why Baker's Debt Plan Won't Work."

That article contends:

> The deep down truth about the debt problem is that the debt is too big for the debtors to handle on a sustained basis. Their burden must be lightened. That can only happen if the banks holding the countries' debt agree to take less from the debtors than they are now demanding. Taking less will mean write downs of the bank loans, the excruciating steps the banks have been avoiding for years.

The article goes on to say:

> In private, some bankers concede the countries can't live with their debt, but in public many are busy lining up behind Baker's plan which would throw more money at the problem. It will simply increase the amount of pain and it will eventually have to be distributed.

Do you share the view that U.S. banks will eventually have to write down at least some of their loans? Are you aware whether it is true that the European banks have already written down or reserved against a larger proportion of their Third World debt exposure than American banks?

Dr. JOHNSON. Well, I think it is true that European banks have reserved more and written down more of their debt. Whether in

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fact American banks will have to experience further writedowns in the future is not clear yet. I think the Baker initiative is one effort that tries to stabilize the growth rates and improve the ability of Third World nations to service their debt and possibly avoid any future restructuring of debts by U.S. commercial banks, and this is not just something that would benefit U.S. commercial banks obviously. This has repercussions throughout the entire economy.

So I think that the initiative that Secretary Baker has undertaken is definitely the right direction and we have a significant chance to avoid any major restructuring in the future and allow Third World nations to improve their capital investments and their domestic economies.

Senator PROXMIRE. What about the private view of many of the bankers that the debtors can't live with the debt they have now and that this makes it worse?

Dr. JOHNSON. Well, I think that we've seen improvement since 1982. I think that when we really had a problem obviously was 1982. Since that time we have had domestic growth. Assets have diversified within the major banks' portfolios.

Senator PROXMIRE. But let me just interrupt to say that that improvement has been spotty, hasn't it, erratic? There are some countries where the situation is worse, particularly countries that rely on oil production?

Dr. JOHNSON. In some cases that's true, but now some of the same lenders to oil-producing countries are also lending to oil-consumer countries in large scale, so it's not clear what the net effect is on the bank balance sheet because even though loans to Mexico may look weaker, loans to energy-consuming countries like Brazil and Argentina may look better.

GROWTH OF M1

Senator PROXMIRE. Now in testimony before this committee last July you criticized what you termed "the erratic short-term pattern of monetary growth in recent years." You went on to deplore the fact that quarterly M1 growth ranged from a minus 1.3 to 17.7 percent annual rate since 1980.

Given your views, I assume that if you become a member of the Federal Reserve Board, you will push for less quarterly variability in money growth. What is an acceptable range for quarterly growth? If it is achieved, how long will it take to reduce real interest rates by the 2 to 3 percentage points that you attribute to excessive volatility?

Dr. JOHNSON. Well, back when I made some of those statements there seemed to be relatively better stability in monetary velocity and the demand for money so that the targets seemed appropriate and to the extent that volatility in money growth exceeded the target ranges and the demand for money appeared to be relatively stable, it was my feeling that the variability in money growth was adding to uncertainty about the future course of Federal Reserve monetary policy and that this might be adding a risk premium to interest rates.

However, since that time, we've seen a fairly significant weakening of monetary velocity and a dramatic increase in the demand

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for money which has made it necessary for the Federal Reserve to revise up its money targets and, in some cases, to simply relax its monitoring of M1 relative to its M1 target because of the huge explosion in the demand for money that caused such a weakness in velocity, which simply meant that even to sustain real GNP growth at stable price levels at reasonably low inflation, a lot more money was needed in the system. This would not necessarily have inflationary consequences because of the tremendous demand for money that was going into checking balances in the form of savings like super NOW accounts that earn interest.

Senator PROXMIRE. I take it your criticism of the Fed at that time no longer applies, is that right, because of the change in the velocity?

Dr. JOHNSON. I think under the current circumstances where it's been necessary to revise up the targets and to some extent even allow M1 to drift above target and the fact that the Fed has made it very clear and provided accurate information to the financial sector that it intends to continue not trying to restrict M1 relative to its targets because of this velocity problem, that that takes away the risk premium.

I think what you've seen is the financial markets relax on that information and we've seen interest rates actually decline as a result.

Senator PROXMIRE. I have one final question. As you look back over the conduct of monetary policy over the last 5 years, what are the major changes you would have pushed for if you had been a member of the Federal Reserve Board compared to the policies actually followed under Chairman Volcker?

Dr. JOHNSON. Well, I have a lot of admiration for the Chairman. I think he's been very courageous in his fight against inflation. I'm on record as not agreeing with every single policy move he's made. There were times when I thought money growth was too restrained, times when in fact I thought it as moving too rapidly. But in general, I think it's been a good record.

Now I think that all I can say at this point is that I would support stable policies and accurate information to the financial markets and oversight groups like this Banking Committee and Congress in general and the administration so that there's a clear understanding of why the Federal Reserve is pursuing the monetary policy it does. As I mentioned, I support earlier disclosure of the FOMC minutes so that financial markets and other observers will get responsive more accurate information about the upcoming course of monetary policy and that this might avoid bidirectional movement in the securities market and the bond market that takes place. I think that if people knew in advance or immediately after a decision by the Federal Reserve Board the direction of monetary policy over the next few weeks that you would get unidirectional movement in the bond market instead of——

Senator PROXMIRE. I was just going to say, you seem to have changed your position vis-a-vis the Federal Reserve Board in general. You say now that in general you think it was a good record, that the Chairman was courageous, he did the right thing. But in testimony just last July, 6 months ago, you termed, as I say, "the

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erratic short-term run pattern of the monetary growth in recent years" you found deplorable.

Dr. JOHNSON. That was referring mainly to 1981 and 1982 which I still have concerns about. I mean, I did think that M1 growth was too slow in 1981 when it undershot the target range and in 1982 when it appeared that the velocity of money was more stable.

Senator PROXMIRE. Wasn't that exactly the time when the Federal Reserve Board took steps which were severe—I admit they were slow, but I thought they were right because they had the effect of stopping the worst inflation we've had in a long, long time.

Dr. JOHNSON. Well, I think that certainly it has dealt very effectively with inflation. There was an economic cost to the GNP and employment. There's no doubt about it. I don't think this was intentional on the part of the central bank by any means. I think that there was plenty of room for disagreement over what the appropriate monetary policy was at that time. There was a lot of fear that very loose fiscal policy was feeding the inflation that was running at double digit rates in 1981. There was concern that that would have to be offset and so you could rationally come to the conclusion that you needed a tighter monetary policy and might want to undershoot your targets, but I happen to disagree. I think that at the time they should have avoided overtightness during that period, but there's plenty of room for disagreement. Inflation was running at double digit rates and there was a reason to be concerned.

However, our view was that passage of tax cut legislation that was phased in over 3 years would not be overstimulative to the economy and we were not suggesting that monetary policy overshoot its monetary targets, just stay in them at the time. So that was my major concern.

Senator PROXMIRE. My time is up, Mr. Chairman. Thank you very much.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

RECIPROCITY WITH THE JAPANESE

Recently a Japanese securities firm filed application with the Federal Reserve Bank of New York to become primary dealers of United States Government securities and I'm wondering—as you know, we're pretty much blocked out of their market in equivalent circumstances. They just make us very unwelcome. But would it be your view that we ought to go ahead and allow the Japanese to become primary dealers of United States Government securities unless and until such time as they accord us exactly equal access and operating privilege in their country?

Dr. JOHNSON. I think in general I support the idea that the Japanese or any other foreign government should be able to deal in securities in the United States. However, I also strongly support their acceptance of our ability to do the same and, of course, in our initiatives at the Treasury on opening up capital markets we have insisted that we be accorded the same access. We've gotten very encouraging responses from the Japanese that they would be willing to accept United States dealers.

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Senator RIEGLE. They haven't done so yet, though, have they?

Dr. JOHNSON. Not to my knowledge.

Senator RIEGLE. I say that because we've had a lot of promises. I could give you as many lists of promises as there are articles that you've written in the last several years here that have been made and not kept by the Japanese.

I assume you are familiar in some detail with the National Commission on Competitiveness' report named and produced for President Reagan. Would I be right in assuming that?

Dr. JOHNSON. Yes.

Senator RIEGLE. Do you agree with and support both the findings and recommendations of that national report in general? I don't want to get into the fine print here.

Dr. JOHNSON. I think I generally support their final recommendations, although if I remember they had proposed a Department for Technology which I'm not sure we need. We have plenty of programs within the current agencies.

Senator RIEGLE. But generally speaking, you found yourself in agreement with the findings, the assessment of the problem, the dynamics at work, and generally the recommendations as to what ought to be done?

Dr. JOHNSON. I would say generically I agreed with a number of the conclusions, but I have to reserve a right in some specifics that I might have had questions with.

Senator RIEGLE. Now I ask that in relationship to the fact that you served on a White House working group on troubled industries. What did that group conclude?

Dr. JOHNSON. Well, it was mainly a monitoring group that tried to keep up to date on the economic condition of various industries that appeared to be troubled. But, it was mainly a monitoring group to provide information to the Cabinet Council on Economic Affairs.

Senator RIEGLE. It was not an action group?

Dr. JOHNSON. It was not an action group. It was a monitoring group.

Senator RIEGLE. And therefore it did not essentially make recommendations?

Dr. JOHNSON. It did not make recommendations. It just briefed on the condition of various industries.

Senator RIEGLE. I want to come back a minute to our discussion on trade because it gets into the way you view problems and issues here and I must say that I have a different feeling than you expressed about the question of who owns our assets in the future because if we find that we have this continued outflow of U.S. capital, which I happen to think is scarce—we've got a lot of claims on capital, we've got huge deficits that a lot of people are running, we've got I think an overexpansion of credit—a lot of different directions—and we've got this hemorrhage of U.S. capital out of the country in exchange for foreign goods to the tune of about $150 billion last year and no end in sight and we've become a debtor nation and it's accelerating and I happen to think it's a real problem. We may differ on that.

But if we get out 4 or 5 years on these trend lines and if the New York Federal Reserve Bank's estimates are right and if we're a net

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debtor nation to the tune of $500 billion or more, when we talked about that a minute ago you were much more sanguine about as long as they're putting the money in here in either debt instruments which in turn are used to finance some kind of investment in the United States or activity or if they invest it in physical plant, the fact that they own the dollars, the dollars are then turned into yen or whatever it happens to be, you seem to feel all right about that.

Let me tell you precisely what my area of concern is because I'd like you to address it if you will. That is, it seems to me that there's a big difference as to whether we're calling our own signals in this country—economic signals and important major economic signals—or whether those signals are being called in Tokyo, or in Bonn, or some other place. I'll just tell you frankly I don't want them called some other place and if we went back 100 years maybe that situation is a little different. We're not going back 100 years and we've got an enormous defense obligation to the free world. We've taken it on. They've been quite happy to have us take it on. The Japanese take a free ride generally speaking, and a lot of others do on this defense spending. You've been part of an administration that has advocated this buildup and has provided for it and foresees it continuing indefinitely into the future into the next century, not just to 1990.

REDEPLOYMENT OF FACTORIES OFFSHORE

I have a very difficult time understanding how you are so sanguine about the question of whether these economic signals increasingly are going to be called in some other national capital or some other foreign firm when assets can be redeployed overnight. I could give you 100 cases of firms that have shut down literally on 1 or 2 days' notice or 1 week's notice and workers come back the next day with the gates locked and literally these facilities have moved halfway around the globe in a matter of literally days in terms of new facilities coming up somewhere else.

Do we increasingly want to be in a position where those kinds of decisions with respect to a large part of the investment productive base of this country are being made that way? I mean, is that not a matter of concern or should we just figure that that's the way the world works and in the notion of sort of free world economics if the signals are called from Tokyo we just have to adjust to that?

Dr. JOHNSON. Well, first let me say that certainly it is possible for companies to pull up roots and move physical capital over time. However, my view is if the right economic climate for investment is maintained domestically in the United States, we don't have a problem, that in fact because of the bright prospects for investment in the United States it would be extremely costly economically for foreign governments as well as any other domestic investor to shift its capital within or outside the region and therefore I think as long as we maintain a set of stable conditions that provide an attractive investment environment in the United States we don't have to worry about that problem unless we're talking about a period of military crisis or something of that nature.

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Senator RIEGLE. But we have had those in our lifetimes and may well again with some of the very countries that are now in this more commanding financial position vis-a-vis the United States.

Dr. JOHNSON. Yes; we do maintain strategic stockpiles to try and deal with particular problems like that. But what I'm saying is, if we maintain a bright investment climate domestically, not only will foreign investors be attracted but given the resources of the United States we will be making a lot of domestic investments and expanding the wealth of the country at the same time.

So I'm not sure if by maintaining a good investment environment domestically we're going to increase foreign claims on the United States in a relative sense.

Senator RIEGLE. Can you give me an example of a major debtor nation today that is seen as a place where lots of other countries now still want to plough in big chunks of new capital and new debt? There's been a general backing away from countries that get themselves overextended. We're backing away from countries that have gotten overextended borrowing from us.

Dr. JOHNSON. I think there are a few, though, that are still in that category. I think some of the Far Eastern countries, like Singapore, Hong Kong at an earlier stage, and Korea are still in that category.

Senator RIEGLE. Of course they're more analog to the way we were several decades ago. In other words, maybe they're at that stage of their development that you cited in our history, but they aren't comparable to us today.

Dr. JOHNSON. There are a lot of investment opportunities there because they still have a lot of development to do, it's true, and rates of return are higher in an environment like that than when you're a fully developed country, there's no doubt; but that doesn't mean that we can't produce policies domestically that improve rates of return in our domestic economy and I think we ought to try and concentrate on that.

Senator RIEGLE. Let me ask you this. Gramm-Rudman is now law. We are mandated under that law to reduce the deficit for the coming fiscal year to $144 billion. The estimates yesterday in the Budget Committee when Mr. Miller was in were to the effect that that basically takes 60 billion dollars' worth of fiscal stimulus, overstimulus, out of the picture.

If we succeed in doing that, and we're mandated by law to do it, do you think there should be a corresponding adjustment in Federal Reserve policy in such a way that we get the monetary benefit, if you will, through lower interest rates or whatever form it would take that in a sense would be the tradeoff that everybody talks about with more fiscal restraint and therefore a monetary bonus that presumably would give us lower interest rates? Would you see that coming and would you work to accomplish that?

Dr. JOHNSON. I think that there's a possibility in a certain way, but I think it's important to describe it.

First, I don't think that you should expect just an automatic voluntary response to budgetary restraint. There's no automatic reason why the Fed ought to loosen monetary policy in response to fiscal spending cuts, mainly because when the Government cuts spending or reduces the deficit those resources are transferred back

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to the private sector and so what you're really doing is you're shifting these resources from the public sector to the private sector. There's no reason for the overall level of demand in the economy to actually change.

If you are cutting Government spending and taking that income that you would have used for Government spending and leaving it in private income, owners of that income are going to spend and save with it and the saving is going to end up in investment so that you've got consumption and investment going on in the private sector. So there's a direct offset between consumption and saving in the Government sector and an increase in consumption and saving in the private sector.

Senator RIEGLE. Is that true of the part of the deficit that's financed by foreign borrowing? Why does that money necessarily appear in the alternative form in the U.S. private economy in a replacement way? Why isn't that perhaps just withdrawn?

DECLINE IN FOREIGN HOLDINGS OF GOVERNMENT SECURITIES

Dr. JOHNSON. To the extent that you're financing some spending out of foreign borrowing, it wouldn't necessarily be an absolute shift over. However, I know that we've brought in a lot of net foreign capital into the United States but there's not a lot of strong evidence that it's been in the form of holding Treasury securities. As a matter of fact, foreign holdings of U.S. Treasury securities have declined as a percentage of the total for several years now, mainly due to the fact that the OPEC countries were the major foreign holders of U.S. securities and with the decline in oil prices we've seen their holdings drop off dramatically. So in fact there are actually lower proportions of foreign holdings of Treasury securities today than there had been several years ago.

But to the extent they exist, it's true that cutting back on spending and reducing borrowing from foreign sources does not necessarily mean a one-for-one shift.

But there is a way in which monetary policy might be responsive in a situation where the deficit was cut substantially by cutting spending if in fact interest rates were to fall as a result of the lower deficit. If people believe there would be less pressure on the Fed to monetize the debt and there would be less pressure on private savings so that interest rates fall relative to the earnings on a checking account or something like a super NOW, it would mean that people would be much more casual about holding their money in the form of M1 type money balances. This would mean there would be further weakness in velocity of M1 money which would have to be offset by a monetary response if you were to try and maintain the economy on the same course as it was before.

One of the major justifications for the Fed's strong money growth over the last year has been the weakness in velocity due to lower interest rates that we've experienced since last summer and if interest rates were to drop further on their own as a result of the cut in the deficit, which is possible if spending is cut substantially, then it might require an additional monetary response to offset the weakness in monetary velocity.

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Senator RIEGLE. That's an interesting point. We've got a vote on, Mr. Chairman. I would like to ask the witness—I'm going to try to finish our conversation privately sometime in the next week or so and indicate an invitation to meet with you.

Dr. JOHNSON. Sure.

The CHAIRMAN. Well, I might also suggest, Dr. Johnson, that there will be questions for your response in writing and when you receive those we would appreciate a response as quickly as you can.

Dr. JOHNSON. Absolutely, Mr. Chairman.

The CHAIRMAN. Thank you very much. We appreciate your willingness to be here today.

The committee is adjourned.

[Whereupon, at 1:40 p.m., the hearing was adjourned.]

[Biographical sketch of nominee and response to written questions of Senators Heinz, D'Amato, Mattingly, Proxmire, Dodd, and Dixon follow:]

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STATEMENT FOR COMPLETION BY PRESIDENTIAL NOMINEES

Name: Johnson (Last) Manuel (First) Holman (Middle) Jr.

Position to which nominated: Governor, Board of Governors Federal Reserve System

Date of nomination: December 10, 1985

Date of birth: 10 February, 1949 (Month, Day, Year) Place of birth: Troy, Alabama

Marital status: Married Full name of spouse: Mary Lois Nilsrann Johnson

Name and ages of children: Marshal Johnson, 7 Merritt Johnson, 4

Education:

Institution	Dates attended	Degrees received	Dates of degrees
University of Alabama	1967-68	N/A	N/A
Troy State University	1971-73	BS	8/10/73
Florida State University	1973-77	MS, Ph.D.	8/22/75, 12/16/77

Honors and awards: List below all scholarships, fellowships, honorary degrees, military medals, honorary society memberships, and any other special recognitions for outstanding service or achievement.

Green Beret, Ranger Tab, Parachute badget, Jungle Expert, Good Conduct Medal, Korean Service Medal; B.S. degree with honors (Cum Laude); Omicron Delta Epsilon (Economics Honor Society); Doctoral Dissertation Fellowship (Nuclear Regulatory Commission); Labor Economics Prize (best research paper in labor economics); Honorary President, Troy State University; Alumnus of the Year 1982 (Troy State University); Honor Award for Outstanding Contributions to Public Policy (Florida State University); Secretary's Honor Award for contribution to first foreign targeted securities issue (U.S. Treasury Department).

Memberships: List below all memberships and offices held in professional, fraternal, business, scholarly, civic, charitable and other organizations.

Organization	Office held (if any)	Dates
Kappa Alpha Order		1967-1968
Omicron Delta Epsilon	Vice-President	1974-1977
American Economic Assoc.		1974-1981
Southern Economic Assoc.		1975-1981
Western Economic Assoc.		1976-1985
Public Choice Society		1978-1981
Regional Science Assoc.		1977-1978

Association of Environmental & Resource Economists - 1979-1981 - No Office Held.

Philadelphia Society - 1980 to present - No Office Held.

Employment record: List below all positions held since college, including the title or description of job, name of employment, location of work, and dates of inclusive employment.

12/10/82 - Present, U.S. Treasury Department, Wash, D.C., Assistant Secretary for Economic Policy

7/27/82-12/10/82, U.S. Treasury Department, Wash, D.C., Assistant Secretary (Designate) for Economic Policy

2/2/82-7/27/82, U.S. Treasury Department, Wash, D.C., Acting Assistant Secretary for Economic Policy

4/27/81-2/2/82, U.S. Treasury Department, Washington, D.C., Deputy Assistant Secretary for Economic Policy

1/24/77-1/31/81, George Mason University, Fairfax, Va., Professor of Economics

9/14/73-12/31/76, Florida State University, Tallahassee, Fla., Instructor and Research Associate

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Government experience: List any experience in or direct association with Federal, State, or local governments, including any advisory, consultative, honorary or other part-time service or positions.

U.S. Treasury Department, Assistant Secretary for Economic Policy

U.S. Treasury Department, Assistant Secretary (Designate) for Econ. Policy

U.S. Treasury Dept., Acting Assistant Secretary for Economic Policy

U.S. Treasury Dept., Deputy Assistant Secretary for Economic Policy

Commissioner, President's Commission on Indian Reservation Economies

Member, President's Steel Advisory Committee

Published writings: List the titles, publishers and dates of books, articles, reports or other published materials you have written.

See attached list.

Political affiliations and activities: List all memberships and offices held in and services rendered to all political parties or election committees during the last 10 years.

Republican National Party

Pike County, Alabama Republican Youth Chairman, 1972

Troy State University Chairman, Students for Winton Blount for U.S. Senate, 1972

Scholars for Reagan/Bush, 1980

BOOKS AND MONOGRAPHS PUBLISHED

The Effect of Deficits on Prices of Financial Assets: Theory and Evidence, U.S. Treasury Department Monograph, Washington, D.C.: U.S. Government Printing Office, March, 1984.

Deregulating Labor Relations, (co-author), Dallas, Texas: The Fisher Institute, 1981.

Better Government At Half The Price: Private Sector Production of Public Services, (co-author), Ottawa, Illinois: Caroline House Publishers, 1980.

The Political Economy of Federal Government Growth, (co-author), College Station, Texas: Texas A & M University, 1980.

Pushbutton Unionism, (co-author), Fairfax, Virginia: Contemporary Economics and Business Association, George Mason University, 1980.

Demographic Trends in Higher Education: Collective Bargaining and Forced Unionism", (co-author), International Institute for Economic Research, University of California, Los Angeles, 1979.

An Assessment of the Impact of Nuclear Power Plant Construction and Operation on Small Regions, U.S. Nuclear Regulatory Commission NUREG Series, Springfield, Virginia: National Technical Information Service, 1978.

PUBLICATIONS IN PROFESSIONAL JOURNALS

"Union Use of Employee Pension Funds: An Overview," (co-author), Journal of Labor Research, Fall, 1981.

"Regional Environmental and Economic Impact Evaluation: An Input-Output Approach," (co-author), Regional Science and Urban Economics, Fall, 1981.

"Tax Limitation Without Sacrifice: Private Sector Production of Public Services," (co-author), Public Finance Quarterly, October, 1980.

"The Future of the Modern University," (co-author), Journal of Social and Political Studies, Fall, 1980.

"Natural Resource Scarcity: Empirical Evidence and Public Policy," (co-author), Journal of Environmental Economics and Management, September, 1980.

"The Efficacy of Bond-Financed Fiscal Policy," (co-author), Public Finance Quarterly, July, 1980.

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"Increasing Resource Scarcity: Further Evidence," (co-author), Quarterly Review of Economics and Business, Spring, 1980.

"The Impact of Right to Work Laws on the Economic Behavior of Local Unions: A Property Rights Perspective," Journal of Labor Research, (co-author), Spring, 1980. This paper received the Labor Economics Prize awarded by the Center for Study of Public Choice for the best research paper on labor issues.

"An Abstract Approach to the Relative Ranking of Economic Journals," (co-author), Nebraska Journal of Economics and Business, Spring, 1980.

"Mathematics and Quantification in Economic Literature: Paradigm or Paradox?" (co-author), Journal of Economic Education, Fall, 1979.

"Quantification and Rigor in the Periodical Literature: Trends and Implications," (co-author), Akron Business and Economics Review, Fall, 1979.

"Free Riders in U.S. Labor Unions: Artifice or Affliction?" (co-author), British Journal of Industrial Relations, July, 1979.

"Paperwork and Bureaucratic Behavior," (co-author), Economic Inquiry, July, 1979.

"Laws of Committee Organization in Bureaucracy," (co-author), The Bureaucrat, Summer, 1979.

"Staff Spending by U.S. Senators: Liberals Versus Conservatives," (co-author), Policy Review, Summer, 1979. This paper was featured in the April 11, 1979 issue of the Wall Street Journal.

"Corporate Contributions: Some Additional Considerations," (co-author) Public Choice, Spring, 1979.

"U.S. Energy Policy and the Energy Crisis: Cause or Cure?" (co-author) Policy Review, Spring, 1979.

"An I-O Model of Regional Environmental and Economic Impacts of Nuclear Power Plants," (co-author), Land Economics, May, 1979.

"Public Versus Private Provision of Collective Goods and Services," (co-author), Public Choice, Winter, 1979.

"The Political Economy of Federal Government Paperwork," (co-author), Policy Review, Winter, 1979. This paper was featured in the lead editorial of the February 12, 1979 issue of the Wall Street Journal.

"Illegal Aliens: Economic and Social Issues," (co-author), Akron Business and Economics Review, Fall, 1978.

"The Energy Crisis in the U.S.: An Economic Perspective," (co-author), Journal of Social and Political Studies, Fall, 1978.

"The Definition of Bureaucrats by Bureaucratic Definitions," (co-author), The Bureaucrat, Spring, 1978.

"Bureaucratic Imperialism: Some Sobering Statistics," (co-author), The Intercollegiate Review, Winter, 1977-78.

OTHER PUBLICATIONS

The Treasury Flat-Tax Plan: Analysis and Comparision," Cato Journal, a symposium entitled "The Flat Rate Tax: An Idea Whose Time Has Come?", sponsored by the Policy Sciences Program at Florida State University, forthcoming.

"Effects of the Monetary and Fiscal Policies of Industrialized Countries on Capital Flows and International Interest Rates," Financial Development of Latin America and the Caribbean, Caracas, Venezuela: International Institute of Capital Markets, 1985.

"The Stability of Monetary Velocity: Fact or Fiction?" (co-author), Research Paper Series, U.S. Treasury Department, August, 1984.

"The Recession of 1981-82: A Supply-Side Perspective," Explanations of the Business Cycle, Norman B. Ture, ed., Washington, D.C.: Institute for Research on the Economics of Taxation, 1983.

"The Flat Tax and Government Growth," The Family and the Flat Rate Tax, Bill Gribbin, ed., Reston, Virginia: American Family Institute, 1983.

"The Administration's Economic Policy: Its Effect on Construction," The Military Engineer, May-June, 1983.

"Economic Forecasting and the Federal Budget," A Reconstruction of the Federal Budget, Princeton University: The Committee for a Responsible Budget, 1982.

"Public Policy for a Growth Economy: Graduation Address to the Troy State University School of Business," Great Issues, Troy, Alabama: Troy State University Press, 1982.

"The Reagan Economic Recovery Program," TSU Business and Economic Review, July, 1982.

"Are Monetarism and Supply-Side Economics Compatible?" Supply-Side Economics: A Critical Appraisal, Richard H. Fink, ed., Frederick, Maryland: University Publications of America, 1982.

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"Private Sector Unions in the Political Arena: Public Policy Vs. Employee Preference," (co-author), Public Policy Analysis and Management, Richard Zeckhauser, ed., Duke University Press, 1982.

"Review of Basic Economics by Edwin G. Dolan," American Economics Texts: A Free Market Critique, James Taylor, ed., Young America's Foundation, 1982.

"Mises on Bureaucracy," History of Economics Society Bulletin, Spring, 1979.

"Paperwork and Public Policy," (co-author), Policy Report, September, 1979.

"Illegal Aliens: Problems and Policies," Legislative Analyses, American Enterprise Institute for Public Policy Research, September, 1978.

"The Renegotiation Reform Act of 1977," Legislative Analyses, September, 1977.

Estimated Historical Impact of Deteriorated Water Quality on United States Coastal Fishery Resources, (co-author), Florida State University, December, 1974.

Adaptation to a Non-Growth Status, Tallahassee, Florida: The State University System of Florida, December, 1973.

Political contributions. Itemize all political contributions of $500 or more to any individual, campaign organization, political party, political action committee or similar entity during the last eight years and identify the specific amounts, dates, and names of the recipients.

None

Qualifications: State fully your qualifications to serve in the position to which you have been named. (attach sheet)

Future employment relationships:

1. Indicate whether you will sever all connections with your present employer, business firm, association or organization if you are confirmed by the Senate.

I will resign from my current position in the U.S. Treasury Dept.
I may retain my extended leave of absence, without pay, from George Mason University.

2. As far as can be foreseen, state whether you have any plans after completing government service to resume employment, affiliation or practice with your previous employer, business firm, association or organization.

If I retain my extended leave of absence with George Mason University, may return as professor of economics after government service.

3. Has anybody made you a commitment to a job after you leave government?

George Mason University has offered to extend my leave of absence without pay.

4. Do you expect to serve the full term for which you have been appointed?

Yes

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Potential conflicts of interest:

1. Describe any financial arrangements or deferred compensation agreements or other continuing dealings with business associates, clients or customers who will be affected by policies which you will influence in the position to which you have been nominated.

None

2. List any investments, obligations, liabilities, or other relationships which might involve potential conflicts of interest with the position to which you have been nominated.

None

3. Describe any business relationship, dealing or financial transaction (other than tax paying) which you have had during the last 10 years with the Federal Government, whether for yourself, on behalf of a client, or acting as an agent, that might in any way constitute or result in a possible conflict of interest with the position to which you have been nominated.

None

4. List any lobbying activity during the past 10 years in which you have engaged for the purpose of directly or indirectly influencing the passage, defeat or modification of any legislation at the national level of government or affecting the administration and execution of national law or public policy.

None other than participation at the U.S. Treasury in development and advocacy of Reagan Administration economic policies.

5. Explain how you will resolve any potential conflict of interest that may be disclosed by your responses to the above items.

None

Civil, criminal and investigatory actions:

1. Give the full details of any civil or criminal proceeding in which you were a defendant or any inquiry or investigation by a Federal, State, or local agency in which you were the subject of the inquiry or investigation.

None

2. Give the full details of any proceeding, inquiry or investigation by any professional association including any bar association in which you were the subject of the proceeding, inquiry or investigation.

None

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Qualifications

Board of Governors of the Federal Reserve System

For the past five years, I have been directly involved with monetary and fiscal policy in the Federal government. As Assistant Secretary of the Treasury for Economic Policy during this period, I often worked closely with the governors of the Federal Reserve Board and their staff. A primary function of this office was to advise the Secretary of the Treasury on all monetary affairs. Therefore, I met weekly with Federal Reserve Board officials to discuss the most pressing issues of financial policy. My duties also required that I serve on the economic forecasting troika (Treasury, Office of Management and Budget, and Council of Economic Advisers) which prepares projections of the economy's performance for estimation of the President's annual budget proposals. Over the course of my tenure at Treasury I have had first-hand experience with the operation of Federal government debt financing and its relationship with monetary policy. In addition, I have participated in development of Administration policies on financial sector regulation and supervision, international lending, and exchange rates.

Prior to my public service with the Treasury, I was a professor of economics at George Mason University in Fairfax, Virginia. During my tenure as a university professor I taught numerous courses in economics and extensively researched a host of topics such as macroeconomics in general and monetary and fiscal policy in particular (see attached list of publications).

If confirmed, I shall do my very best to serve the Nation well as a member of the Board of Governors of the Federal Reserve System.

ANSWERS TO QUESTIONS SUBMITTED BY SENATOR HEINZ

From Manuel H. Johnson

Question 1 from Senator Heinz:

Despite many signs of continuing health in the U.S. economy, a number of disturbing imbalances cloud the horizon.

-- The trade deficit is at record levels and still rising.

-- The value of the dollar, although below the peak level of early 1985 in part due to a more active intervention policy, is still at a level commensurate with continuing large current account deficits.

-- And the federal budget deficit, although now subject to limits imposed by Gramm-Rudman, remains enormous.

The U.S. is a net debtor nation and U.S. exporters face tremendous competitive odds. How urgent for the continued health of the overall economy and the U.S. trade position are these steps to correct financial imbalances? Are the steps being taken sufficient?

Answer:

In line with the thrust of your question, many have attributed economic difficulties largely to the strength of the dollar in foreign exchange markets, which is frequently tied to high interest rates, which in turn are tied to the high Federal budget deficits. Though I have difficulty in agreeing with that chain of logic, I accept the sincerity with which those concerns are expressed. At the same time, I should point out that our economy generally has been producing jobs at a remarkable pace -- some 9 plus million since the trough of the last recession. That is a pattern which one expects from a growing, vibrant economy. That is in marked contrast with anemic employment growth in other major industrial trading nations, which in a number of instances have registered little if any employment growth over the past decade. Those were countries which generally experienced depreciating currencies from 1980 through early last year.

The U.S. cannot carry alone the responsibilities required for the growth of the international economy, and that is why the G-5 nations have agreed to policy steps to foster more balanced, stronger growth abroad, and also to take steps which lead to depreciation of the dollar. Our major trading partners can adopt policies that will both ameliorate their employment difficulties and spur economic growth. These steps would alleviate some of the current strains in the international economic environment. At the same time, the U.S. must cut the Federal budget deficit by cutting the rate of growth in Federal expenditures where the problem clearly lies. This step will return resources to the more productive private sector and help blunt the criticism of our friends abroad.

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It is frequently asked how long the U.S. and the world economy can live with the present imbalances, as partly reflected by our large current account deficit, and whether the steps taken or in process are sufficient to counteract those strains. No one can pinpoint exactly as to when foreigners will become overloaded with dollar holdings. There are certainly few signs of that at the present time. It seems to me that we would be ill-advised to bargain away, for purposes of bringing the dollar down, the steps we have taken domestically to set our economy on a more solid footing. The dollar has been attractive to foreigners because of the higher returns available in this country because of the investment policies adopted by the Reagan Administration. We hope that other nations will embark on similar paths for the good of their peoples and the world economy generally. There is solid evidence that some such steps are in the process of being implemented. Combined with our own domestic initiatives on the Federal spending front, I am confident and optimistic that we are on the verge of a stronger, better balanced expansion of the international economy. However, the sooner we are able to stabilize the debt situation in the developing world through such measures as the Baker debt initiative, the sooner capital flight from these countries will stop and allow the dollar to settle at a more sustainable level.

Question 2 from Senator Heinz:

Concerns have been expressed that the massive deficit position of the U.S. vis a vis the rest of the world could lead to a loss of confidence in the U.S. economy, resulting in a rapid drop in the value of the dollar and capital inflows, and to a rise in inflation. Actual experience over the last year has been of a gradually falling exchange rate and modest inflation. What do you believe are the prospects for a continued steady decline in the dollar without a notable increase in inflation or the drying up of foreign capital inflows -- a so-called "soft-landing"? How should monetary policy be used to address a more rapid decline in the dollar or increase in inflation?

Answer 2:

As I indicated in my answer to the prior question, the strength of the dollar has reflected the attractiveness of U.S. dollar-designated investments, which have yielded a higher return because the prospective returns available on U.S. investment are higher under the policies adopted since the Reagan Administration came into office. Because of that, I tend to think that the dollar has been desired more because of better investment opportunities; and capital came into this country despite the Federal budget deficit and not because of it. Obviously, if the Federal deficit were to be allowed to run unchecked for an indefinite period, foreign investors might begin to question the ability of this country to provide an environment conducive to private sector growth and investment. That is one of the reasons why we need to cut Federal expenditures, because if we do not, sooner or later there might be some loss of confidence in U.S. policy, with possibly deleterious consequences both domestically and internationally. If we can check the growth in Federal expenditures, maintain and design new incentives for investment, while at the same time growth is promoted in foreign countries by private sector incentive-oriented policies, the dollar may well move lower as funds would then have alternative outlets abroad.

It is my view that after all is said and done, foreign exchange values sooner or later reflect the relative economic fundamentals at play in the various countries. For the longer term health of the economy, I would seek a stable monetary policy, sufficient to fund sustainable real growth at relatively stable prices. It would be extremely important to avoid a monetary policy that might ignite inflationary pyschology and cause a sharp fall in the dollar.

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Question 3: A more active intervention policy has been instituted by the G-5 countries to ensure that the values of the major currencies accurately reflect the relative strengths of their economies. How important do you believe exchange market intervention is to the value of the dollar, and how do you see this more active approach affecting U.S. monetary policy?

Answer:

The Plaza Announcement of September 22 focused attention on the fundamental role of favorable convergence of economic performance and mutually consistent and reinforcing policies among countries, in determining exchange rate relationships. Exchange market intervention is widely recognized as a policy tool with only limited use over the long run as a substitute for basic economic policies, in influencing exchange market trends. Thus there is no real inconsistency between use of the intervention tool in the context of convergence of fundamentals of economic performance, and a monetary policy stance which supports sustained noninflationary growth at home.

Question 4: The Omnibus Trade Bill introduced in the Senate contains a number of provisions intended to further reduce the value of the dollar. These include:

-- A possible monetary conference to consider improvements to the world monetary system;

-- Enhanced coordination of G-5 monetary and fiscal policies to promote convergence of key economic factors such as inflation, interest rates and money growth; and

-- Establishment of a Strategic Exchange Reserve in which foreign currencies would be accumulated to increase the value of non-dollar currencies and make U.S. participation in foreign exchange markets more effective and credible.

With regard to these provisions, do you believe any significant changes are needed in the monetary system and that a monetary conference should be considered? How important to future economic health is convergence of G-5 policies, and how would you see such cooperation affecting the conduct of U.S. fiscal and monetary policy? Do you believe that accumulation of a foreign exchange reserve would be an effective tool for foreign exchange intervention?

Answer:

I share the concern of many Members of Congress that the international monetary system needs to be improved. Discussions are now underway within the International Monetary Fund on possible improvements within the international monetary system. The Interim Committee will be meeting in April to discuss reports by both the Group of Ten industrial countries and the Group of 24 developing nations on these issues. Secretary Baker has already indicated our willingness to consider the possible value of hosting a high-level meeting of the major industrial countries to follow up on the Group of Ten's proposals on improving the international monetary system; he remains prepared to do so if at some future date such a meeting appears to be useful. I believe that at this stage it would be premature to determine the need for an international monetary conference to address these issues.

I believe it is very important that progress be maintained in the convergence of performance and policies among the G-5 countries, which was the focus of the September 22 meeting. At the recent (January 18-19) meeting in London, to take stock of developments since September 22, G-5 Finance Ministers and Central Bank Governors expressed satisfaction with progress made so far, and agreed that this cooperation should continue.

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Finally, I believe that the creation of a Strategic Currency Reserve to intervene in exchange markets is unnecessary. One of the purposes for which the Treasury's Exchange Stabilization Fund (ESF) was established was to enable the Secretary to intervene in exchange markets and existing legislation establishes broad guidelines regarding the purposes for such intervention. We have been intervening under existing ESF authority and guidelines as part of the Group of Five agreement on September 22, 1985, to encourage exchange rates which better reflect recent and prospective improvements in underlying economic conditions. The proposed Strategic Currency Reserve unnecessarily restricts the Treasury's flexibility by tying intervention to a narrowly defined exchange rate objective.

(Question #5 from Senator Heinz)

Question:

Despite the decline in the value of the dollar during 1985, the U.S. merchandise trade deficit remains at record levels. Export-led and import-sensitive industries have borne the brunt of the high dollar. Do you believe there has been any permanent weakening of the U.S. manufacturing sector due to the high dollar, and how soon do you foresee improvement in the trade deficit as a result of declines in the dollar during the last year?

Answer:

It is true that the high dollar of the last several years has acted as a drag on the manufacturing sector. And the dollar has not been the only problem. Many of our trading partners have experienced only sluggish economic performance while our own economy was growing rapidly. This imbalance in growth has also contributed to the trade deficit.

I believe that the impact of these factors is only temporary and certainly see no evidence of any permanent weakening in manufacturing. Growth of output in the goods-producing sector of the economy -- which is mostly manufacturing -- has been stronger in this expansion than in any of the previous four post-Korean war expansions. Many observers express concern over the fact that growth of employment in service industries is outpacing that in manufacturing. They fail to notice that this has been pretty much the pattern of the post-World War II era. One reason for the slower growth of employment in manufacturing is the faster productivity growth. Productivity in the manufacturing sector has advanced at a 2.5 percent annual rate since 1950, compared to growth at only a 1.8 percent pace for the entire nonfarm business sector.

There is also no evidence of any serious loss of competitive advantage in the manufacturing sector. In spite of two back-to-back recessions, by 1985 U.S. industrial production had advanced 12-1/2 percent above the 1979 level. This was a much healthier performance than occurred in Canada, France, Germany, Italy, or the United Kingdom, several of which registered declines over that five-year period.

During 1985 industrial production slowed and employment in manufacturing edged lower through much of the year. I expect that the decline in the dollar should result in some improvement in the trade deficit certainly by the end of 1986, although lags between currency realignment and any effect on the trade deficit make it difficult to pinpoint the timing exactly.

It is worth noting, however, that there already appears to be some pickup underway in U.S. manufacturing activity. Employment in this sector has now increased for three months in a row, after sagging earlier in the year. Industrial production has risen strongly two months in a row. I have considerable confidence in the ability of the U.S. industrial sector to produce high-quality, technically advanced products with worldwide markets and expect that manufacturing industries will continue to register progress in the year to come.

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Question:

Given the size of the U.S. trade deficit, there is strong support across the United States for measures to improve the competitive position of U.S. exporters. One such step was passage of the Export Trading Company Act in 1982. What are your views of the export trading company concept?

Answer:

The Export Trading Company Act of 1982 (1) delineated circumstances under which banks could engage in non-banking, export oriented business; and (2) clarified existing antitrust laws by clearly identifying, in the form of a certificate, which export activities were permitted by law. The Administration strongly supported the bill because it removed unnecessary barriers to exports. It has not contributed to dynamic export growth, but that seems to be more the result of the strong dollar and weak demand overseas, than to any innate shortcoming of the legislation itself.

Question:

Since the original legislation passed, it has become clear that a number of impediments have limited the effectiveness of the law and the impact of trading companies. I have introduced legislation (S.1934) to provide further guidance to the Federal Reserve on the appropriate relationship between banks and affiliated export trading companies. These amendments would clarify the definition of ETCs and relax certain restrictions on member bank investment in and transactions with ETCs being applied by the Federal Reserve, while fully maintaining Federal Reserve authority to protect the soundness of member banks. Could you comment on these provisions?

Answer:

These provisions seem to have considerable merit but I would need to study their potential impact more carefully than has been possible to this time. Since the Administration supported the original legislation and these amendments appear to be designed simply to improve its operation, I am naturally inclined to support the amendments. I understand that comments have been requested from the Board of Governors on this proposal and that Senate Hearings are expected to be scheduled for March or April. I would want to follow these subsequent developments very carefully before attempting to reach a final judgment.

ANSWERS TO QUESTIONS SUBMITTED BY SENATOR

From Manuel H. Johnson

Question:

On January 8, 1986, the Federal Reserve Board (FED) adopted an interpretation of Regulation G. This interpretation applies the margin requirements of Regulation G to the financing of corporate takeovers through the use of junk bonds. The intrepretation represents a departure from the FED's earlier position on this subject.

a) Do you agree with the FED's January 8, 1986 interpretation?

Answer:

No, if the purpose was to regulate corporate takeovers. However, my understanding is that the Fed was asked for a clarification of the rules governing margin requirements and that there was no intent to regulate takeovers.

Question:

b) If you take issue with the January 8, 1986 interpretation, could you please state your position.

Answer:

Further regulation of financing of corporate takeovers is unnecessary and a detriment to the market achieving the most efficient use of private capital. In particular, I believe that use of margin requirements to regulate corporate takeovers is improper. The Fed has already indicated that margin requirements have probably outlived their usefulness. I think too much attention has been given to the Fed's recent interpretation of regulation G. The Fed's interpretation indicates a very narrow application of the regulation.

Question:

c) The interpretation was supposedly limited to certain transactions. What do you perceive to be the limits of the interpretation?

Answer:

The Fed modified the proposal on January 8 to limit it to debt issued by shell corporations for the purpose of acquiring margin stock, and excluded situations in which (i) the shell corporation's debt is guaranteed by an operating company; (ii) there is a merger agreement between the shell and the target; or (iii) the obligation to lend to the shell is contingent on the shell acquiring sufficient stock to accomplish a "short-form merger" without further stockholder or director approval. While I welcome these limitations, I continue to be concerned not only about the basic question whether the interpretation should have

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been issued at all, but also with the ambiguity of the definitions of both shell corporation and operating company. Because of that ambiguity, the interpretation may be used by target company management or disappointed potential acquirers to delay acquisitions.

Question:

d) Do you think a distinction should have been made between the application of the January 8, 1986 interpretation to hostile takeovers and friendly acquisitions or leveraged buyouts that are financed thorugh the use of junk bonds?

Answer:

First, I want to emphasize that the interpretation is not limited to use of junk bonds; any debt issued to finance a stock acquisition is potentially subject to the interpretation. Beyond that, since my preference is that the interpretation not have been issued, I believe hostile and friendly takeovers should have been treated similarly--not at all. However, given that the Fed did decide to issue the interpretation, I welcome any limitation.

Question:

e) At present, foreign investors who finance acquisitions through foreign borrowing are not subject to the requirements of Regulation G. Should legislation be enacted that would require the application of the margin rules to these foreign investors?

Answer:

Although I intend to keep an open mind on the subject as I study it further, my current inclination is to support a repeal of the margin requirements as archaic and ineffective to accomplish the congressional goals of minimizing both instability in the markets and the draining of capital to speculative activities. Obviously, if the margin requirements were repealed, there would be no need to apply them to foreign investors. If they are not repealed, I think we should take a serious look at any inequities resulting from the non-applicability of the rules to foreign investors, taking into account questions such as whether and how application of the rules to such investors could be enforced and what such a rule would mean in terms of limiting United States access to foreign capital.

Question:

f) Last year a FED Study recommended the repeal or modification of the 50% margin requirement. Do you support the recommendations of this report?

Answer:

See prior answer.

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Question:

The Banking Committee has been examining the issue of deposit insurance reform for several months. Part of this inquiry has focused upon the adequacy of the minimum capital reserves maintained by banks. Last week the Comptroller of the Currency proposed a plan that would eliminate the current mandatory requirement that banks maintain a minimum 6 percent capital-to-assets ratio. The Comptroller recommended promulgating new rules that would set banks' minimum capital reserves solely by the riskiness of their investments. By contrast, Fed Chairman Volcker proposed calculating capital reserves according to risk but retaining the 6 percent requirement as a base.

a) Do you believe that the minimum capital adequacy reserves of banks should be increased?

b) Do you believe the plan proposed by Chairman Volcker or that of the Comptroller provides a more appropriate solution?

Answer:

I have been very supportive of the regulators' efforts to raise minimum capital requirements. Adequate capital levels are essential to reduce the exposure of the deposit insurance funds and to maintain banking system stability. I concurred with the recommendation of the deposit insurance study conducted by the Working Group of the Cabinet Council on Economic Affairs that calls for an increase in capital requirements.

I have supported the concept of risk-based capital requirements consistent with the findings of the Federal Reserve Board. I have not yet had an opportunity to study the Comptroller study.

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Q. Congress has been contemplating several legislative proposals that would impose minimal regulation on the previously unregulated market in government securities. Do you believe that the authority to act as the principal regulator should be invested in the FED, the Treasury Department or a self-regulatory organization?

A. First, let me state that in order to implement effectively monetary policy and to minimize the cost of financing the federal debt, it is essential to maintain both the efficiency and the integrity of the government securities market. Given the dealer failures of the last several years, I believe that continued confidence in the market requires some additional regulation. Regulation is needed, on the scale proposed in your [Senator D'Amato's] bill and the Treasury bill submitted to Congress on December 6. However, I am seriously concerned that there is a danger of over-regulation of what is essentially a market of institutional investors that will impede the market's essential efficiency. I have not had a chance to study alternative regulatory proposals carefully. However, any proposal should probably require some cooperative supervision between the Fed and Treasury.

Question:

At present Bankers Trust Company, Morgan Guaranty Bank, and Citicorp have applications pending before the FED that would permit these institutions to undertake no-banking activities by, in essence, asking the FED to redefine the term "engaged principally" as found in section 21, paragraph 7 of the Glass-Steagall Act. Do you believe that the FED would be acting within its statutory authority by granting these applications and, by doing so, essentially redefining the term" engaged principally"? Shouldn't the definition or re-definition of this term be left to Congress?

Answer:

In commenting on the applications of Citicorp and J. P. Morgan to underwrite and deal in certain securities to a limited extent, the Justice Department concluded that those proposals are consistent with the Glass-Steagall Act. Their comment stated that

> ... the "engaged principally" language of Section 20 reflects a congressional judgment to allow a bank's affiliate, as distinguished from the bank itself, to underwrite and deal in bank-ineligible securities as long as such activities do not constitute the affiliate's major or most important activity. Therefore, since both the Citicorp and Morgan applications provide that only a small proportion of each affiliate's total activities will consist of underwriting and dealing in ineligible securities, both proposals are consistent with section 20 of the Glass-Steagall Act.

Consistent with the recent Supreme Court decision in the Dimension case, the Justice Department adopts the view that neither the courts nor the Federal Reserve Board are free to ignore the plain meaning of Glass-Steagall's language and replace it with some other approach that they believe to be more reasonable based upon policy grounds. Since the "engaged principally" language of Glass-Steagall is not specifically defined in the statute, the Justice Department's reliance on the ordinary meaning of those words and the legislative history is eminently reasonable.

The extent to which commercial banks should participate in securities activities is an extremely timely and significant question which should be considered by Congress in the context of its comprehensive review and proposals for reform of the financial services industry. That reform should focus on promoting the safety and soundness of the financial system while recognizing the additional concerns of consumer convenience and competitive equity.

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Question:

Last year the Supreme Court held that commercial paper was included within the scope of the definition of a security under the federal securities laws. However, certain banking institutions continue to underwrite and distribute commercial paper. Do you intend to prohibit commercial bank activity in this area upon your approval to the Board?

Answer:

As you have stated, the Supreme Court has determined that "commercial paper" constitutes a "security" for purposes of the Glass-Steagall Act which generally prohibits banks from underwriting, distributing, or dealing in securities. However, as the Supreme Court recognized in that same case, federal banking laws also expressly authorize banks to engage in selling securities for the account of customers. Therefore, if a bank carries out a transaction involving a security, that particular transaction must be examined to determine if it constitutes that type of transaction that is expressly authorized or if it constitutes an activity that is prohibited under Glass-Steagall.

The Supreme Court case to which you refer involved the commercial paper activities of Bankers Trust Company of New York. After deciding that commercial paper constitutes a security for purposes of federal banking law, the Supreme Court remanded the case to the lower court for specific consideration of whether Bankers Trust's commercial paper activities fell within the prohibited types of transactions. After obtaining a detailed description of the activities from Bankers Trust and carefully analyzing the legal issues, the Federal Reserve Board concluded that the commercial paper activities currently engaged in by Bankers Trust constituted the sale of securities for a customer that is expressly authorized and that the activities did not constitute prohibited underwriting or distributing of securities to the public.

What is clear as a result of this case is that bank involvement in commercial paper transactions must be examined on a case-by-case basis to determine if the activity constitutes an authorized security transaction or a prohibited form of underwriting or distribution. The analysis of the Federal Reserve Board in the Bankers Trust case provides guidance for drawing this distinction with respect to commercial paper activities, keeping in mind the hazards that Congress intended to prevent through the Glass-Steagall Act, such as investment of bank assets in speculation or liquid assets.

As a member of the Board, I would expect to support examination of such activities using the general guidelines set forth in the Bankers Trust case.

Question #6 from Senator D'Amato

Question:

Many commentators contend that America has become over-leveraged and that corporations and individuals face a debt crisis of huge proportions. Do you believe that such a crisis situation exists? If so, what action should the FED take to discourage the growth of corporate and personal debt?

Answer:

I do not believe that the growth of debt over the past few years can be viewed as representing a crisis situation, nor do I think that we are heading in that direction. The debt situation is something that should be watched carefully, and certainly some segments of the economy face serious problems, but overall the economy appears to be functioning smoothly at the present time.

Much has been made of the debt situation in the household sector, where the ratio of consumer installment debt to after-tax personal income reached a record 18.9 percent in November. That ratio is somewhat exaggerated, however, by the increasing use of credit cards instead of money to effect transactions. Further, the numbers are probably boosted by the fact that the baby-boom generation is now in the family formation and rearing years when acquisition of consumer durables is typically large. These are generally bought on credit.

High levels of household indebtedness must be weighed against high levels of asset holding. During the expansion, financial asset holdings of households have grown even faster than debt. Overall, while household indebtedness may be a mildly constraining force on growth of consumer spending in the future, it should not be a factor which would curb the current expansion. Nor do households appear so leveraged as to exacerbate any downturn, should one occur. Of course, no one fully understands this area, and it is one that I will be monitoring carefully in the future.

On the corporate side, the recent growth of debt partly reflects the restructuring underway in a number of industries. Firms in those industries may have considerable cash flow, but investment within those industries may no longer be attractive because of shifts in relative prices. The natural outlet for that cash flow is investment in other areas, often in the form of acquisition of other firms. An offshoot of this may be the substitution of debt for equity. All this is part of the process of directing resources to those industries and areas where they can most profitably be put to use -- a process which can only enhance prospects for future growth.

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Markets apparently do not believe that corporations have become overburdened with debt, as bond yields, both for top quality and for lesser quality issues, have come down about 100 basis points since last summer and about 200 basis points from a year ago, despite large bond offerings. Many investors were badly burned during the period of rising inflation and economic uncertainty of the 1970's, and would be expected to be very careful in Committing new funds. They do not appear to be skittish about the future.

Certain segments of the economy do face serious problems. Farmers took on large debt burdens during the period of rising inflation and rising land values. The process of winding down inflation has hurt them badly, and it will take some years to repair the damage. Overall however, the economy generally does not appear to be too highly leveraged. I would note that we have a tax system that encourages leverage. Proposals made by the Administration would reduce the incentives for that leverage by lowering marginal tax rates.

As for the role of the Federal Reserve System, aside from its responsibilities for bank regulation, its primary focus should be directed at setting the appropriate framework of reserves and monetary aggregates so that the economy may grow along a sustainable, noninflationary path. The Board and the District Banks have highly competent staffs, but they surely are not capable of acting as policemen to oversee the financial behavior of U.S. corporations and households.

ANSWERS TO QUESTIONS SUBMITTED BY SENATOR MATTINGLY

From Manuel Johnson

Question:

What is your attitude generally toward the Glass-Steagall Act and what, in your opinion, should the Federal Reserve Board do in this area to prohibit banks from engaging in nonbank activities?

Answer:

The original intent of the Glass-Steagall Act of 1933 was to try and avoid future risk exposure to bank depositors from speculative investment practices by commercial banks and their securities affiliates. This purpose is still an admirable objective today. However, the financial services industry has evolved dramatically since 1933. Many of the regulations designed to protect depositors and restrict banking practices have become outmoded due to financial innovation and technology. Commercial banks are losing funds because they are becoming uncompetitive with other financial service firms for customers.

In order for commercial banking to remain competitive, it seems to me that the Glass-Steagall Act should be modernized. This reform might involve allowing commercial banks to engage in more securities type activities through bank holding companies, but at the same time providing a deposit insurance system that requires banks to reserve capital or pay insurance premiums based on the riskiness of their investments. Such a change would internalize the risk of investment to commercial banks or their holding companies while at the same time protecting depositors and allowing banks to be more competitive.

Question:

Citicorp, Bankers Trust and Morgan Guarantee Bank have applications now pending before the Federal Reserve Board that would redefine the term "engaged principally" so as to allow these commercial banks to engage in securities and other nonbanking activities. In light of yesterday's decision on the Dimension Case before the Supreme Court, which struck down the Fed's redefinition of a bank, what action (if any) do you believe should be taken by the Fed to redefine the term "engaged principally?"

Answer:

In commenting on the applications of Citicorp and J.P. Morgan to underwrite and deal in certain securities to a limited extent, the Justice Department concluded that those proposals are consistent with the Glass-Steagall Act. Their comment stated that

> ...the "engaged principally" language of Section 20 reflects a congressional judgment to allow a bank's affiliate, as

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distinguished from the bank itself, to underwrite and deal in bank-ineligible securities as long as such activities do not constitute the affiliate's major or most important activity. Therefore, since both the Citicorp and Morgan applications provide that only a small proportion of each affiliate's total activities will consist of underwriting and dealing in ineligible securities, both proposals are consistent with section 20 of the Glass-Steagall Act.

Consistent with the recent Supreme Court decision in the Dimension case, the Justice Department adopts the view that neither the courts nor the Federal Reserve Board are free to ignore the plain meaning of Glass-Steagall's language and replace it with some other approach that they believe to be more reasonable based upon policy grounds. Since the "engaged principally" language of Glass-Steagall is not specifically defined in the statute, the Justice Department's reliance on the ordinary meaning of those words and the legislative history is eminently reasonable.

The extent to which commercial banks should participate in securities activities is an extremely timely and significant question which should be considered by Congress in the context of its comprehensive review and proposals for reform of the financial services industry. That reform should focus on promoting the safety and soundness of the financial system while recognizing the additional concerns of consumer convenience and competitive equity.

Question:

What is your attitude generally toward the merger and acquisition activities in the economy, and what should the Federal Reserve Board do in this area?

Answer:

Further regulation of financing of corporate takeovers is unnecessary and a detriment to the market achieving the most efficient use of private capital. In particular, I believe that use of margin requirements to regulate corporate takeovers is improper. The Fed has already indicated that margin requirements have probably outlived their usefulness. I think too much attention has been given to the Fed's recent interpretation of regulation G. The Fed's interpretation indicates a very narrow application of the regulation.

The Fed modified the proposal on January 8 to limit it to debt issued by shell corporations for the purpose of acquiring margin stock, and excluded situations in which (i) the shell corporation's debt is guaranteed by an operating company; (ii) there there is a merger agreement between the shell and the target; or (iii) the obligation to lend to the shell is contingent on the shell acquiring sufficient stock to accomplish

a "short-form merger" without further stockholder or director approval. While I welcome these limitations, I continue to be concerned not only about the basic question whether the interpretation should have been issued at all, but also with the ambiguity of the definition of both shell corporation and operating company. Because of that ambiguity, the interpretation may be used for target company management or disappointed potential acquirers to delay acquisitions.

Question:

Will it be your intent to seek reopening of the recent Junk Bond limitations imposed by the Fed on hostile mergers: if so, why?

Answer:

As stated in my response to the question above the Fed has expressed its opinion that margin requirement regulations are probably no longer necessary. If action is taken to address the margin requirement rules, I see no reason to revisit the Junk Bond interpretation.

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ANSWERS TO QUESTIONS SUBMITTED BY SENATOR PROXMIRE

From Manuel H. Johnson

Question:

On July 17th 1985 the New York Times carried an article entitled "The Market for Latin Debt" in which is is stated that many banks with Latin American debts are finding relief by selling them in a secondary market. The article noted that several of the big money center banks have refused to discuss this development. It then said, "One reason for the reticence of the bankers and brokers is that the transactions provide tangible evidence that many Third World loans are not worth their face value and the big banks fear that the regulators would cite that as a reason to require loan loss reserves."

In May of 1985 the banking committee of the American Institute of Certified Public Accountants ruled that banks that swap loans must discount the loans on their books if they received less than face value.

Do you agree with that ruling by the accountants? Do you think if the market is saying that various of the third world loans are not worth their face value this is a good reason for the regulators to require additional reserves against such loans? Do you think that the regulators should make the banks set aside reserves against any loans that are swapped for less than their face value?

Answer:

Certainly, many banks have swapped debt; others have sold it at a discount to change the composition of their portfolio and asset holdings. I don't see anything untoward in this.

I see no reason to object to the AICPA ruling that you cite. This reflects a case situation where the loan has actually been sold in the market and a loss recorded. I think the situation of paper still in a portfolio can differ.

If particular paper were being sharply discounted in the market, I would expect that prudent bank mangers would on their own increase reserves and possibly write-down some loans. But circumstances can differ. If the debt on the books were being serviced in a timely manner, if the country were making adjustment efforts, were in compliance with or negotiating an IMF program, such measures might not be needed. The actual response would need to be considered and determined by regulators on a case by case, borrower by borrower basis.

Question:

On June 24, 1985, the Joint Economic Committee, on which I also served for over 20 years, held a hearing on the international debt problem. One witness, a senior vice president of Shearson-Lehman Brothers, said "The banks should consider writing off part of the debt for unless the burden of adjustment is more evenly shared between debtors and creditors the price, both political and economic, could be very high." The witness stated further, "Preston Martin is right in pointing to the need for more imaginative schemes. The cost of an interest cap, World Bank guarantees, the stretching of maturities, the cancellation of some debt, is a small price to pay compared to the consequences of economic and political chaos in the developing world and the repercussions in the U.S."

Since then the Baker Plan was announced at the IMF/World Bank meeting in Korea. Do you think that Plan is adequate to deal with this problem or will some of the other measures mentioned above also have to be taken?

Answer:

I expect that the Baker Plan (or Program for Sustained Growth) will be adequate to deal with many aspects of the problem but there is no guarantee of success in every case. The Program is complex. It involves each of the major participants, the debtor countries, the MDBS and the commercial banks making a significant effort. Recall the main points:

First and foremost, it is essential that the debtor nations adopt comprehensive macroeconomic and structural policies to promote growth and balance of payments adjustment, and to reduce inflation. Such programs should include:

-- increased reliance on the private sector;

-- more supply-side actions to mobilize domestic savings and foster efficient investment; and

-- greater emphasis on market-opening measures to encourage foreign direct and portfolio investment, capital inflows, and trade.

Second, the proposal recognizes that the International Monetary Fund has played a central role in the implementation of the international debt strategy and emphasizes that this should continue. At the same time, it is also important for the World Bank and other multilateral development banks (MDBs) to play a stronger role to supplement that of the IMF.

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In particular, the U.S. has called for increased and more effective structural and sector adjustment lending by the MDBs. We envisage a 50 percent increase over current World Bank and Inter-American Development Bank (IDB) disbursements to the principal debtor nations, to $9 billion annually for 1986 through 1988, or a total of $27 billion for the full period. This would be equivalent to an increase of 20 percent a year in overall exposure, after scheduled repayments, or $20 billion in net new lending over the three years.

Third, we estimate a need for $20 billion in net new lending by the commercial banks in support of growth-oriented policies by the debtor nations over the next three years. This is equivalent to a 2.5 to 3 percent annual increase in current bank exposure.

If each of the participants does its part, and the demand for quality lending by the World Bank increases, we indicated that we would also be prepared to look seriously at the timing and scope of a general capital increase for the World Bank.

Implementation of the debt strategy will be a long and complex process. It will not involve a single event marking the beginning of operations. Indeed, the process is already well underway. Nor does the U.S. debt initiative provide a rigid "plan" or "blueprint" for action which can be applied in full to each of the principal debtor nations. Implementation will be on a case-by-case basis with the initiative providing a framework for cooperative action to support the debtor nations' own efforts to improve their growth prospects. This will depend on the individual situation in each debtor country, and each country's decision to implement the additional growth-oriented measures which are needed to supplement adjustment efforts already underway.

These views are not original; they echo the Administration's description of the Program, but I believe the Program can work.

Regarding the commercial banks more specifically, U.S. banks accounting for 95 percent of the U.S. commercial bank exposure in the principal debtor countries have pledged their support, as have national banking groups and key individual banks in all major countries.

I believe it is up to the commercial banking community to devise its own mechanisms for implementing its commitment to increase net lending in support of growth-oriented economic programs in the debtor nations. A number of ideas are now under discussion. I do not believe in using government guarantees for this purpose. The Program is not a bank bail-out. The approach being followed provides a means for improving the quality of outstanding commercial bank loans and is strongly in the banks' own self-interest in those countries that are undertaking sound, growth-oriented adjustment.

Of course, in the extreme case, it is possible that some of the debtor countries will not make the appropriate adjustment efforts, may not service their debt, and may further damage their creditworthiness. If such cases develop, it would be appropriate for banks to increase provisions for bad debt and possibly write-off a portion of the debt. Indeed, there have been cases where the regulatory agencies appropriately have mandated such action, through establishment of accelerated transfer risk reserves (ATRR). The Baker Initiative offers a better alternative, provided the countries concerned are willing to make the necessary effort.

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Question:

In your July 2, 1985 speech before the Western Economic Association you contended that the U.S. budget deficit was not and is not responsible for the appreciation of the dollar that has occurred since 1981. You contended in that speech that the dollar appreciated because of our country's "sound economic policies and higher after-tax real rates of return as investment in the United States."

As you know most reputable observers do not agree with your analysis. Despite that -- and accepting your analysis of why the dollar has appreciated so rapidly and as a consequence made it very difficult for our farmers and manufacturers to export -- what can we do to remedy the problem. What actions can our government take to bring the dollar into a more realistic ratio to other currencies? Those who blame the bloated dollar on high interest rates have a simple remedy -- cut the budget deficit. What is your prescription for curing the problem?

Answer:

It is hard to understand how "most reputable observers" could come to the conclusion that large U.S. budget deficits would be responsible for causing the U.S. dollar to appreciate on the scale observed after 1980. Surely large budget deficits as such would be associated with a very weak and depreciating currency. That has uniformly been the case for other countries. Why should the U.S. be different? The other obvious difficulty with that line of explanation is that during the period when successive estimates of budget deficits have been rising, interest rates have been falling. In 1980 when the prime rate peaked at 21-1/2 percent the budget deficit was about $75 billion. Now the deficit is over $200 billion and the prime rate is 9-1/2 percent. Clearly the simple deficit theory of the behavior of the dollar and interest rates is seriously defective.

The more sensible line of explanation, which accords with the facts, is that the reduction of U.S. inflation, the 1981 tax cuts and the move to market-oriented policies promoted a gigantic net inflow of private capital for investment in this country. As a consequence, the price of the dollar was driven up more or less steadily until early 1985. A factor contributing to the net inflow of capital was also the reduction of U.S. lending abroad, particularly to Latin America, as prospective rates of return declined there and rose in the U.S. Foreigners did not invest in the U.S. because of our budget deficits but despite them.

As the question suggests, however, the important issue is not whose theory is intellectually more satisfying, but what can be done in the present situation to ease the heavy burden which has come to rest on key sectors of the economy, both industry and agriculture. It is clear that the G-5 initiative under Secretary Baker's leadership has had a very beneficial effect and we need to build further on that foundation. Foreign countries must be urged to agree up their domestic economies and promote more vigorous growth. Further initiatives must be pursued to insure that American products are not treated unfairly in markets abroad. Beyond that, it will be essential to pursue sound economic and financial policies at home and to assist depressed sectors of the economy to make as smooth a transition as possible to a generally less inflationary environment.

Question:

Some FED watchers have suggested that regardless of what the FED says it is targeting, it is really targeting real GNP growth. That is, when the FED thinks the economy is growing too fast in real terms, it steps on the monetary brakes, and when it thinks the economy is growing too slow, it steps on the monetary gas peddle. My question to you is two-fold:

(1) Do you think this is an accurate description of how monetary policy is actually made?

2 Do you think the real rate of GNP growth is an appropriate target for the FED?

Answer:

The description does seem to describe Fed actions fairly well, particularly at some times in the past. However, the Fed's concentration on real growth may have been somewhat more apparent than real. For example, at times when the Fed seemed to be interested in choking down on real growth, it may in fact have been chiefly concerned with the associated rise in inflation which it may have felt would eventually undercut real growth in any event. At times when the Fed has been engaged in aggressive easing, the objective could be described in terms of real growth or perhaps equally well in terms of preventing a cumulative downward movement in economic activity. Also, the Fed has apparently at times in the past given some weight to international considerations, domestic financial stability and other factors.

The promotion of real growth should certainly be a short-term objective of the monetary authorities although major reliance should probably be placed on fiscal measures to raise the after-tax rate of return on private sector activity. The monetary authorities probably should aim primarily at the achievement of a stable but adequate rate of growth in money and as low a level of interest rates as possible. However, this assumes that there is a considerable degree of stability in the demand for money. When this is not the case, the Fed's task becomes more complex and the promotion of real growth is likely to become more difficult.

In longer run terms, it is unlikely that the Federal Reserve can or should aim at the stimulation of real growth. It is generally recognized that long run real growth is determined by more basic non-monetary factors such as the size and skill of the labor force, the pace of capital formation, and the incentives for private saving. Indeed, there are risks in the short run that the unqualified pursuit of real growth will only lead to inflation and the eventual disruption of economic expansion.

While the pursuit of real growth should be regarded as highly important by the Fed, their primary impact inevitably is felt through financial channels and chiefly affects financial magnitudes. Even their ability to affect nominal GNP, for example, may be seriously compromised when velocity behaves in an unstable manner.

In short, while real growth must rank high among our national economic objectives it simply is not a realistic primary operating target for the Federal Reserve.

QUESTION:

I introduced an amendment to the Banking Bill which the Senate took up in 1984, to include foreign deposits in the FDIC premium base. As you know many of the large money center banks have half or more of their deposits in their foreign branches and pay no premiums against these deposits even though they are 100 percent de facto insured by the FDIC.

One of the arguments raised against this proposal is that it would put our large banks at a competitive disadvantage against foreign banks. What do you think of my proposal and the argument raised by the money center banks against it?

ANSWER:

Your proposal, as I understand it, would extend the deposit insurance premium base to include foreign deposits and reduce the premium rate from 1/12th of one percent to 1/15th of one percent. The effect of these two changes would be revenue neutral.

Although your plan would slightly reduce the insurance premium for thousands of small banks, it would significantly increase the costs for large international class banks and would not increase the size of the insurance fund.

I think Congress and the Administration must consider: (1) whether the benefits of this plan outweigh the competitive problems it will create in the international lending market and (2) to what extent the plan will strengthen the safety and soundness of the deposit insurance system.

In the past, I have suggested that there might be more effective ways than foreign deposit insurance assessments to increase safety and soundness and protect the insurance funds. These would include increasing capital requirements for depository institutions and introducing risk-related pricing for federal deposit insurance. However, your plan deserves serious consideration.

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There has been considerable debate in the last few years [illegible] whether the Federal Reserve ought to be allowed any discretion in the conduct of monetary policy. Those against discretion argue that a discretionary policy is inherently destabilizing and that monetary policy ought to be conducted according to a strict rule. The nature of the rule varies from [illegible] measure of money to some measure of price such as gold, foreign exchange rates or commodity prices.

Those against a rule-based monetary policy argue the economy is too complex to be run in accordance with a simple rule. They say that any rule will not cover all the situations arising in a dynamically changing economy and that the monetary authorities must be allowed discretion.

Without getting into the question of what is an appropriate rule, where do you stand on the question of discretion versus a rule? Should the Federal Reserve be allowed discretion, or should we seek to constrain its policies with a rule?

Answer:

The debate over rules versus discretion in monetary policy seems likely to continue into the future with neither of the extremes of a simple rigid rule or total discretion being executed successfully. There has been some movement in recent years toward greater application of a monetary rule -- in the sense of trying to stay within predetermined targets for monetary growth -- and a lively debate continues over alternative ways in which a rule or rules might be implemented. It is infrequent in this day and age to find much support for a total grant of absolute discretion to the monetary authorities. It would probably be correct, therefore, to infer that the case for a monetary rule has been gaining ground.

Advocates of a monetary rule argue that recent experiments here and abroad have not constituted a fair test. It is difficult to avoid feeling some sympathy for their position. They need to face up to the fact, however, that a monetary rule focusing upon the quantity of money can be executed successfully only if monetary velocity displays some measure of stability. While velocity seemed to be stable during much of the period following World War II, sophisticated statistical testing suggests that even that degree of stability has frequently been overestimated. No refined statistical tests are needed to show that velocity has been extremely unstable during the 1980's.

Therefore, some discretion in applying any monetary rule has been essential recently. For example, during 1985 the rate of growth in M1 was approximately 12 percent and monetary velocity fell at roughly a 5 percent annual rate. Real growth was sluggish during much of the year although recession never threatened. We cannot know with certainty what would have been the effect on the economy if the Federal Reserve had been forced by rigid application of a monetary rule to hold the rate of growth in M1 to some lower figure -- for example 6 percent which would have been near the middle of the target range at the beginning of 1985. There is a strong presumption, however, that the economic results would have been serious, adverse, perhaps even recession.

This does not mean that we should move from year to year by stating monetary targets and then abandoning them. It suggests that some latitude for monetary discretion is an insurance policy against velocity or other surprises. During settled conditions with a stable demand for money, monetary policy can perhaps safely be placed on automatic pilot. During periods of economic turbulence, there will probably be a need to take a more activist stance. The monetary authorities must always be cautious, however, lest their own zeal for activism end up by introducing an additional degree of instability into the process.

More research and experience are needed before a monetary rule or rules can safely be applied, but the effort to develop a more rule-oriented approach needs to continue. At the worst, a grant of total discretion could allow the monetary authority to do whatever it pleased, without being subject to such if any discipline. Few people would regard that as a healthy state of affairs.

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Question:

Chairman Volcker has expressed concern about the rise in corporate debt. For example, in 1984 and 1985 nearly $60 billion of corporate equity was exchanged for debt. As a result, the corporate debt/equity ratio has risen sharply.

Some suggest the rising levels of corporate debt are making the economy far more vulnerable in the next economic slow-down.

Others suggest that more corporate debt is a good thing -- that it keeps corporate managers on their toes since they must meet the interest payments.

Where do you stand on this issue. Is the rising level of corporate debt a threat to the economy, or is it a blessing in disguise?

Answer:

An increase in debt, by itself, certainly cannot be counted as a blessing, but the increase we have witnessed during the current expansion does not appear to be cause for alarm. Debt of nonfinancial corporations increased by a quite modest 5.0 percent during 1983, by a sizable 15.9 percent during 1984, and then by 5.1 percent, annual rate, during the first three quarters of last year. (The wrap-up of fourth-quarter figures is not yet available.) Over that entire period, growth of debt of the nonfinancial corporate sector was a little less than for all other nonfinancial sectors of the economy combined. Typically, corporate debt expands rapidly during the second and third years of expansion, which are the years of large capital investment.

The debt situation needs to be put in perspective. The commonly cited debt/asset ratios exaggerate the debt situation, as the assets are based on book values. If assets are capitalized at market values, such ratios currently are well below postwar highs.

Much of the substitution of debt for equity during the past two years appears to relate to a restructuring of the economy, or at least of a number of industries. Due to shifts in relative prices, new investments within certain industries have become less attractive, while firms within those industries continue to experience a sizable cash flow. The natural outlet for that cash flow is investment in other industries, and that has frequently taken the form of a buyout of other firms. All this is part of the process of shifting resources into areas where they can most profitably be put to work, a process which can only enhance prospects for longer-run economic growth.

The markets themselves are perhaps the best judge of whether corporations have become overburdened with debt. Investors in bonds were badly burned by the rising rates of inflation and uncertain economic environment of the 1970's, and can be expected to undertake careful assessments of the long-run prospects for the economy and for particular firms before committing new funds. The markets have taken in stride the large bond offerings of the past year or so. Despite these large offerings, corporate bond yields are now about 100 basis points below levels of last summer and 200 basis points below yields of a year ago. There is no particular evidence of any flight to quality, such as might be expected in a period of financial uncertainty. Spreads between AAA and BAA rated corporate bonds have been little changed for over two years and substantially narrower than in the 1980-83 period.

I note that internally generated funds of nonfinancial corporations (in the third quarter of last year (the latest for which data are available) more than covered the total capital expenditures of those corporations. This is an unusual development for that stage of the cycle and is indicative of the relatively sound financial position of most corporations.

I would finally point out that one of the incentives for debt as opposed to equity financing will be reduced if marginal tax rates are lowered in accordance with Administration tax-reform proposals. Overall, I don't view the rise in corporate debt as cause for serious concern at the present time, but it is a situation which I will continue to monitor closely.

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Question:

There are some who argue that bank deregulation has run its full course and that banks should not be granted any new powers. Others continue to argue that banks need new powers in the area of real estate, insurance, and securities if they are to compete with other financials services conglomerates. What are your views -- do you favor expanded powers for banks and bank holding companies or should we hold the line?

Answer:

The changing nature of the financial services industry and the growth of diversified financial services firms have given both depositors and borrowers a much broader array of potential providers for services traditionally offered by depository institutions.

Although banks and thrifts have been able to expand into some new services, they have not been able to achieve the same degree of diversification as have other financial services firms. Specifically, securities firms and retailers now offer all the products available at depository institutions, while banks and thrifts are still excluded from the core product areas of these firms.

The expansion of other diversified financial services firms into traditional banking areas has been one factor contributing to a decline in commercial banks' share of business loans, consumer credit, and the financial assets held by all private financial institutions.

In light of the expansion of other financial institutions into the banking area and the declining market share of banks, I believe that an expansion of bank and thrift holding company product powers is a critical step in enabling depository institutions to compete on an equitable basis for customers.

The Administration (myself included) supported the Garn Bill which passed the Senate in 1984. It would have authorized bank and thrift holding companies to underwrite and deal in municipal revenue bonds, mortgage-backed securities and commercial paper. In his testimony last June Secretary Baker indicated that the Administration would like to add to this list of proposed additional powers for depository institution holding companies two further activities: (1) authority to sponsor, distribute and advise mutual funds, and (2) authority to engage in activities "of a financial nature" and determined by the Federal Reserve. As Assistant Treasury Secretary I supported this position.

At some future date it might be appropriate to authorize depository institution holding companies to engage in more activities in the securities, insurance, etc. fields. However, I would prefer to examine the performance of depository institution holding companies using the powers proposed before considering authorizing them to engage in additional activities.

Question:

There has been some talk about merging the FDIC and the FSLIC in order to strengthen the latter institution. According to studies by the Bank Board's staff, the potential losses from under water thrifts could exceed $15 billion while the FSLIC has less than $4 billion in un-encumbered reserves.

What are your views on this issue? Should we merge the two institutions, or should we try to keep them separate?

Answer:

I agree with the recommendation of the Vice President's Task Group on Regulation of Financial Services that the FSLIC and FDIC establish a uniform regulatory approach, including common accounting and minimum capital standards to be phased in over time if necessary. These steps would make it easier to merge the insurance funds and agencies should it become appropriate. Merging the FSLIC and FDIC at this time could well be premature given the differences in both the financial condition and the nature of insured risks among the different types of insured organizations. The Task Group has reached the same conclusion.

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Agricultural Credit

QUESTION:

Congress has before it a number of proposals for easing the agricultural credit crisis. One idea is to extend the net worth certificate program provided to thrift institutions to agricultural banks. Another proposal is to allow agricultural banks to defer loan losses over a longer period of time rather than taking the entire hit when the loan is written down. Many banks have urged that agricultural banks be afforded the same relief Congress made available last year to the farm Credit System.

How serious is the farm credit problem, and what proposals, if any, would you recommend for dealing with it?

ANSWER:

It has been estimated that about 120,000 commercial farmers accounting for about 12 percent of farm assets are experiencing substantial financial stress and will need to develop some kind of workout plan if they are to continue farming. Many of these, however, will not be able to undertake additional borrowing and will have to liquidate their holdings and discontinue their operations. Several studies within and outside the government have found that adequate credit is available at reasonable interest rates to creditworthy borrowers in rural areas. Even bank failures have been less disruptive than they might have been because of prudent FDIC policies. The FDIC testified in late November that it had reopened 40 of the 50 farm banks that had failed. Declining farm income is the primary factor causing many farmers to undertake major adjustments in their debt structure.

I do not believe current farm credit problems pose a serious threat to the national lending systems. Recent legislative and administrative actions will aid adjustments in the rural credit systems and new programs are not necessary at this time. For example, the Farmers Home Administration obligated nearly $6 billion in loans to finance farm ownership and operation during FY 1985 and expects to obligate over $5 billion again in FY 1986. In addition, the 1985 farm bill includes a $490 million interest rate reduction program to aid banks in writing down interest rates on farm loans. The farm credit legislation enacted late last year will help the system to provide funds at a lower cost to farm operators, enable the System to deal more effectively with problem loans and cash flow problems, and reassure farm borrowers that their investment in the system is secure. Finally, the regulatory agencies have reemphasized long-standing policies to avoid supervisory actions that may discourage banks from working with farmers to restructure their debt obligations.

Consequently, I would not propose new legislative actions at this time. In particular, I do not support the extension of the so-called "net worth certificate" program to agricultural banks nor the "loss amortization" proposals that have been suggested. Indeed, such efforts to move away from consistent and accurate accounting practices could undermine public confidence in these banks without improving their actual financial health.

Proposals for administrative actions that would promote diversification of loan portfolios in rural credit institutions should be given serious consideration, however.

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Question:

The House is about to pass legislation requiring banks to make checks deposited by consumers available in two or three business days. As you know, some banks restrict availability for ten days or even longer. Many consumers have complained about this practice.

What are you views on this issue? Do you support the passage of legislation such as the bill being considered by the House?

Answer:

The "Expedited Funds Availability Act" passed by the House on January 23, 1986, addresses signficant consumer concerns. Consumer groups have pointed out that some banks deny consumers access to their deposits while the banks profit from "float" on checks that usually clear within a few days.

However, the Administration believes that the House bill is unnecessarily rigid and prescriptive. It could result in the imposition of substantial costs on depository institutions. These costs would, in all likelihood, be passed on to consumers of bank services.

The Senate's "Fair Deposit Availability Act of 1986", which was passed by the Senate in 1984 as part of the Garn bill, addresses consumer concerns in a more realistic and attainable way. This bill would require depository institutions to notify depositors of their funds availability policies and would give the Federal Reserve Board needed flexibility with regard to improving the check clearing system and expediting the availability of depositors' funds.

Credit Card Interest Rates

Question:

Consumer groups have charged that the rate of interest charged by banks on credit cards is way out of line with the bank's cost of funds. They point out that while all other interest rates have come down, credit card interest rates have stayed the same or gone up. I am told that some banks charge as much as 24 percent.

Senator D'Amato has introduced a bill to put a federal ceiling on credit card interest rates. Do you agree that credit card interest rates are too high, and if so, do you favor federal legislation to control them?

Answer:

There are a number of factors involved in determining the interest rate banks charge on various types of loans other than their cost of funds. Among these factors are processing costs, which for credit cards are relatively high because of the numerous small transactions involved, and the risk of default. I am not a banker and cannot presume to be able to determine the level of interest rate appropriate for various types of loans.

I do observe, however, that credit card rates have traditionally been high but have generally remained quite stable. I am attaching a chart from my March 17, 1983 testimony before the Subcommittee on Consumer Affairs of the Senate Committee on Banking, Housing, and Urban Affairs. The chart shows that over the decade from 1972 to 1981, when 3-month Treasury bill rates soared 10 percentage points, the rate charged on credit cards edged up only about 1 percentage point.

Placing a federal ceiling on credit card interest rates would serve no useful purpose, in my opinion, and would most likely end up harming the consumer. Such a ceiling amounts to a price control which would distort the efficient allocation of financial resources that characterizes our market economy.

According to the 1983 Survey of Consumer Finances, close to half of credit card holders use their cards as a substitute for cash. They nearly always pay their outstanding balance in full and thus are not affected by the high rates. A substantial portion of revenues from bank card plans, on the other hand, are derived from finance charges. If interest rates were held artificially low, banks would probably be forced to take several types of action that would be detrimental to consumers. Among other things, banks might try to reduce credit card losses by

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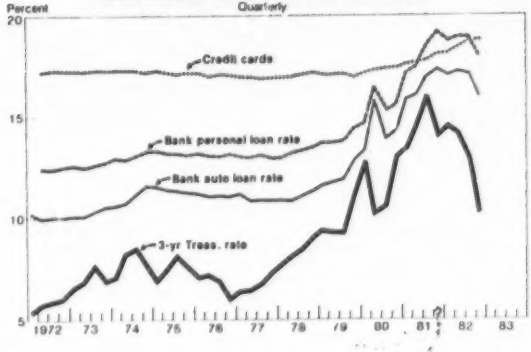
rationing credit, they might raise the cost to merchants of presenting credit card receipts; or they might raise the annual fees. All of those actions would have a major impact on consumers, including those who rarely use the revolving credit function of their cards.

The credit card industry appears to be one of intense competition, with numerous financial companies continually adding new services and vying for new customers. There has even been evidence lately that some banks are starting to lower financing charges voluntarily. The fact that nearly two-thirds of American families hold at least one credit card indicates that consumers are largely satisfied with the offerings available to them. Attempts to legislate usury ceilings for credit cards would only disturb what now appears to be an active and smoothly functioning consumer market for credit.

COMPARISON OF 3-YR TREASURY RATE AND SELECTED BORROWING RATES



January 24, 1984

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Question:

In testifying before the Joint Economic Committee in October of 1983, you said: "It appears that the secular trend of deficits, if kept at a sustainable level may be more conducive to economic growth than if the corresponding amount of funds was raised by taxing the productive factors in the economy."

I am not sure what you meant by this, but it sounds as though you believe there is some permanent, acceptable level of budget deficits that not only are tolerable, but are actually desirable. Is this what you meant, and if so, what is the desirable level of budget deficits?

Answer:

It may help to clarify the intent of the sentence in question to repeat the sequence of argument in that section of my October 1983 statement before the Joint Economic Committee. The passage reads as follows:

"One can only speculate on the effect of continuing deficits on interest rates and, more fundamentally, on economic growth.

In brief, for some combination of elasticities of supply of labor and private savings, a given structure of marginal taxes, a composition of government expenditures (in terms of growth-enhancing and growth-retarding categories), and other parameters, there will be some sustainable level of secular budget deficits relative to GNP, that is essentially not resulting in an explosive growth of the debt-to-GNP ratio. It is not possible to state a priori what that level might be but it need not necessarily be zero. The sustainable deficit-to-GNP ratio would be higher the greater are, among others, the responsiveness of supply of labor and savings to net rate of return; marginal output-to-labor and output-to-capital ratios; average marginal taxes; and the proportion of productive investments in total government spending. But satisfactory econometric estimates of these parameters do not exist yet.

However, simulations (performed by IMF economists among others) based on a range of reasonable values of relevant parameters indicate that the effects of tax rate cuts on the supply of aggregate output, while rather weak in the short run, may, in the long run, dominate the demand, i.e., the stimulative, effect. Therefore, it appears that the secular trend of deficits, if kept at a sustainable level may be more conducive to economic growth than if the corresponding amount of funds was raised by taxing the productive factors in the economy."

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The intention of the passage was not to suggest that there is some optimal level of the deficit which can be known with precision in advance, but simply that there is in principle some sustainable long-run level or levels of the deficit -- not necessarily equal to zero. The sentence to which the present question refers, went on to point out that given some sustainable level of the deficit, it might be better (in terms of economic performance) to persist with that situation rather than to raise taxes since tax increases have long-run disincentive effects on the private sector and thereby reduce real growth.

It will readily be recognized that the deficit concept employed in the discussion was long-run in nature incorporating effects on the supply of output, rather than the simple Keynesian concept of the deficit as a tool of demand management. The purpose was simply to isolate for analytical purposes the fact that in the long-run the tax-related effects on supply are quite likely -- indeed, in my opinion almost certain -- to outweigh any stimulative effects emanating from the budget.

Question:

I would like to get your view on the interplay between fiscal and monetary policy. One view suggests that monetary policy should be influenced by fiscal policy. That is, if the President and the Congress are pursuing a loose fiscal policy, the Fed needs to temper the effect with a tighter money policy. Those who hold this view argue that if the Federal deficit can indeed be cut through Gramm-Rudman, that the Fed can then loosen up on the monetary reins.

The opposite view suggests that monetary policy should be conducted with a view towards long-term price stability and stable growth and should not be influenced by fiscal policy.

What is your view on this issue?

Answer:

The question states very concisely two competing views of the fiscal-monetary relationship. The first view, emphasizing the opportunity of varying the fiscal-monetary "mix", had its origins in the Keynesian view that fiscal and monetary policy should be partners in the task of demand management. Monetary policy was usually viewed as a junior partner and given the task of keeping interest rates as low as possible, while fiscal policy played the major role. The long-run role of the money supply in determining inflation was largely ignored or even denied and as inflationary pressures did develop the fiscal-monetary mix was supplemented by some form of wage-price policy. This view of the fiscal-monetary relationship still persists to some degree, but the generally unsatisfactory results to which it led by the late 1970's has greatly reduced its influence.

The opposite view emphasizes the role of monetary policy in determining the level of prices and views fiscal policy primarily in terms of determining the division between the public and private sectors rather than the overall level of activity. This would come somewhat closer to my own thinking if supplemented by a recognition that long-run real growth is determined by real, supply-side forces. It should be emphasized in passing that there always is a potential, and clearly undesirable, linkage between fiscal and monetary policy if budget deficits are routinely monetized. It is assumed for the purpose of this discussion, that respect for the traditional independence of the Federal Reserve rules out such a possibility.

It is questionable in my opinion whether any clear linkage, or quid pro quo, can or should be established between cuts in the structural budget deficit and monetary policy. If those cuts are accomplished, as they should be in my opinion, through cuts in expenditure the empirical evidence with which I am familiar suggests that real interest rates are likely to fall. The idea that a fiscal move in one direction can or should be offset by a monetary move in another direction is open to serious question. I would not want to rule the possibility out in all circumstances, but I would feel the burden of proof should rest on those who urge that such a change in policy mix would be beneficial. The past evidence for beneficial effect is not very convincing.

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ANSWERS TO QUESTIONS SUBMITTED BY SENATOR DOLE

From Manuel H. Johnson

Question:

A group called "Citizens for a Sound Economy" produce a newsletter entitled "Capital Comment" and the January 21st edition is entitled "Manuel Johnson--Fresh Ideas for the Fed." While they do not quote you, they seem to believe that you support the notions they support. Therefore, I would like to get your views on some of the ideas they support:

First, the publication says that "the variability of the money growth rate around its average has been almost twice as high under Paul Volcker as in the next highest period, during the 1940's. Not surprisingly, output and employment have also followed an unpredictable pattern. A steady growth rate will be one of Johnson's primary goals in his new post."

Do you think the variability of the money growth rate has been a problem in recent years and, if so, how would you propose the Fed go about achieving a steady growth rate?

Answer:

It is certainly a statistical fact that the variability of money growth has increased substantially since 1979. As this year's Economic Report points out, the standard deviation of quarterly M1 growth increased from 2.2 percent in the 6-year period prior to October 1979 to 4.8 percent in the 6-year period thereafter. Some recent specific examples also serve to make the point. From October 1980 through July 1982, the annual rate of growth in M1 was 4.8 percent. It then more than doubled to a 10.4 percent rate from July 1982 to June 1984 before slowing abruptly to a 4.1 percent annual rate between June 1984 and December 1984. Since December 1984, M1 growth has accelerated once again to an 11.8 percent annual rate.

Empirical work at the Treasury and elsewhere suggests that this high degree of variability in monetary growth has been responsible for holding short-term real interest rates several hundred basis points higher than they might otherwise have been. In this clearly defined sense, monetary variability has been a problem.

It is only fair to recognize, however, that the Federal Reserve has had to cope with a difficult situation. Institutional change and other factors have caused monetary velocity to behave in an unpredictable manner. Paradoxically, this has meant that some variability in monetary growth has been necessary and beneficial to offset shifts in the demand for money. That seems rather clearly to have been the case in 1985 when literal adherence to low monetary targets might well have turned the moderate retardation of real growth into something more serious.

It is partly an informational problem in that the Federal Reserve should probably convey its intentions with respect to the monetary targets more clearly than it has at times in the past. Markets are understandably disturbed when the Fed persistently overshoots (or undershoots) its targets at a time when it professes to be attempting to operate within them. If the Fed were simply to state that for a certain period of time, because of shifts in the demand for money, literal adherence to the monetary targets would not be attempted, the end result in terms of financial market performance and real activity would probably be improved.

In situations where the demand for money is stable, there may well be certain changes in operational procedure which the Fed might implement in the pursuit of less variable monetary growth. One should not be dogmatic on these issues but the vast amount of day-by-day Fed intervention in the market and the consequent churning almost inevitably leads to some degree of de facto targeting of interest rates by the Fed. This leads almost inevitably to more variable money growth.

In short, there are periods when variable monetary growth is desirable to offset fluctuations in velocity, but on balance the Fed probably has caused more monetary variability in recent years than it should have. The difficulty, which should not be minimized, is in diagnosing in advance whether or not the demand for money has shifted. The Fed should in uncertain situations examine a range of other indicators such as prices, foreign exchange rates and financial market performance in order to assess their proper course of action.

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Question:

Second, Capitol comment says that "overlapping regulatory agencies, laws forbidding interstate branch banking, and restrictions prohibiting financial institutions from offering a full range of services all result in higher costs and reduced consumer choice". It goes on to support nationwide banking, family banks and permitting banks to engage in insurance, brokerage services "and other fields."

Do you think we should change the banking laws to permit the items mentioned or, if you think the list should be different, what legislative changes would you support?

Answer:

Holding Company Activities

The Administration (myself included) supported the Garn Bill which passed the Senate in 1984. It would have authorized bank and thrift holding companies to underwrite and deal in municipal revenue bonds, mortgage-backed securities and commercial paper. In his testimony last June Secretary Baker indicated that the Administration would like to add to this list of proposed additional powers for depository institution holding companies two further activities: (1) authority to sponsor, distribute and advise mutual funds, and (2) authority to engage in activities "of a financial nature" and determined by the Federal Reserve. As Assistant Treasury Secretary I supported this position.

At some future date it might be appropriate to authorize depository institution holding companies to engage in more activities in the securities, insurance, etc. fields. However, I would prefer to examine the performance of depository institution holding companies using the powers proposed before considering authorizing them to engage in additional activities.

Interstate Banking

Now that the Supreme Court has confirmed that states can join together to form regional compacts, I believe Congress should address the issue of a trigger mechanism for nationwide interstate banking. Secretary Baker indicated in his testimony last June that five-years would appear to be a reasonable time period within which regional banks could make the transition to full interstate banking. I do not believe, however, that the issue of an interstate banking trigger should detract from Congressional attention to more important legislation regarding deposit insurance reform and expanding the permissable activities of depository institution holding companies.

Regulatory Reform

The Administration, in consultation with the Federal Reserve Board of Governors, has proposed that certain initial steps be taken to restructure the regulation of financial services with an emphasis placed on the principle of regulation by function. The starting point proposed by the Administration is found in the July 1984 study "Blueprint for Reform: The Report of the Task Group on Regulation of Financial Services." The major proposals of the "Blueprint" are outlined in the attached "Appendix". I was involved in this study and generally support the recommendations.

It is worth highlighting the fact that the study does not propose to eliminate any of the current federal banking agencies, although a streamlining of their regulatory responsibilities is suggested. Thus, the Federal Banking Agency (FBA) would replace the Office of the Comptroller of the Currency (OCC) as a Treasury Department agency and would assume all of the duties of the OCC with respect to regulating national banks; all state chartered banks as well as major bank holding companies would be regulated by the Federal Reserve Board; and the FDIC would no longer be involved in the regulation, examination and supervision of state non-member banks (concentrating instead on its responsibilities as an insurer of deposits). In addition, most bank holding companies would be regulated by the primary regulator of their lead bank. While by no means extreme, these measures would result in a more logical realignment of bank regulatory responsibilities than we have currently.

Attachment

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Appendix

The Major Proposals of the Blueprint for Reform

1. The three existing federal bank regulators would be reduced to two by eliminating the FDIC's role in examining, supervising and regulating state non-member banks. A new "Federal Banking Agency" ("FBA") would be created within the Treasury Department, incorporating and upgrading the existing OCC. This agency would regulate all national banks, while the FRB would be responsible for federal regulation of all state-chartered banks.

2. The regulation of bank holding companies would be substantially reorganized. At present, the FRB regulates all bank holding companies, even though a different agency usually regulates the subsidiary bank(s) of the holding company. Under the new system in almost all cases the agency that regulates a bank would also supervise its parent holding company. This would make it possible for most banking organizations to have a single federal regulator rather than two.

3. The FRB would transfer its authority to establish the permissible activities of bank holding companies to the new FBA, although it would maintain a limited veto right over new activities.

4. The FRB would continue to supervise the holding companies of the very largest domestic banks, as well as those with significant international activities and foreign-owned institutions.

5. The FDIC would be refocused exclusively on providing deposit insurance and administering the deposit insurance system. All its current responsibilities for environmental, consumer, antitrust and other laws not directly related to the solvency of insured banks would be transferred to other agencies, as would its responsibilities for routine examination, supervision and regulation of state non-member banks. At the same time, the FDIC would assume new authority to review issuance of insurance to all institutions, as well as to examine all troubled institutions and a sample of non-troubled firms in conjunction with the primary supervisor. The FDIC would also have new authority to take enforcement action against violations of federal law concerning unsafe banking practices in any bank examined by it where the primary regulator failed to take such action upon prior request of the FDIC.

6. A new program would transfer current federal supervision of many state-chartered banks and S&Ls (and their holding companies) to the better state regulatory agencies, creating new incentives for states to assume a stronger role in supervision.

7. The special regulatory system for thrifts would be maintained, but eligibility would be based on whether an institution is actually competing as a thrift, rather than on its type of charter.

8. The FDIC and FSLIC would be required to establish common minimum capital requirements and accounting standards for insurance purposes.

9. Antitrust and securities matters would each be handled by a single agency rather than five different agencies at present.

10. Some specific regulatory provisions would be simplified to eliminate unnecessary burden. These include existing legislative provisions that encourage wasteful litigation, as well as outdated application requirements in various areas.

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Question:

Finally, the newsletter supports private deposit insurance, a viewpoint that has not been widely shared by the witnesses before this Committee. Do you support private deposit insurance?

Answer:

In 1985 a working group of the Cabinet Council on Economic Affairs completed a study entitled "Recommendations for Change in the Federal Deposit Insurance System". The study addressed the feasibility of both private deposit insurance and private coinsurance. It concluded that neither was very practical. I would refer you to the discussion of these subjects on pages 54-56 of the study which I have attached. I support these findings. During my hearing I supported the alternative concept of risk based capital requirements in addition to the current deposit insurance system. The Federal Reserve Board has endorsed such an approach.

Attachment

v. Privatization

Currently there are six state chartered, or state regulated, private deposit insurance companies that primarily insure deposits in state chartered savings and loan associations. These private insurance companies, however, generally insure institutions with under $100 million in assets and the largest number of institutions insured by any one private insurer is 145. In addition to their capital, five of the deposit insurance companies have increased their financial resources through lines of credit with commercial banks and two have reinsurance contracts with two general insurance companies.

While private or state insurers might serve as coinsurers with the federal government for certain classes of deposits, the private sector appears unlikely to provide all deposit insurance. Furthermore, it is doubtful whether supplemental private insurance is likely to be supplied. Certainly, virtually none has been marketed for deposits over $100,000 or for money market funds. Totally private deposit insurance is unlikely for at least three significant reasons. First, external economic conditions may adversely impact all banks at the same time. The systemic nature of the risk makes the provision of insurance itself highly risky.

Second, there were over $2.1 trillion of demand, savings and time deposits held in commercial banks and thrifts at year-end 1983. Although most of the $2.1 trillion is not at risk because of assets available to cover it, private insurance firms may still not be able to obtain the capital necessary to support such insurance. The FDIC estimated that, in 1981, the maximum legal capital of all domestic property and liability insurers, including domestic reinsurance organizations, could cover $7.5 billion of deposits at any one institution. This amount is well below the level of uninsured deposits at the largest commercial banks. In light of self-imposed exposure limits, a more realistic estimate is that $1 to $2 billion in coverage per institution might be available.

Third, there are external social and political benefits in maintaining a stable financial system that do not accrue to individual banks within the system. A totally private insurance system would, therefore, be likely to provide too little insurance for the total system and tend to minimize losses by closing troubled institutions too early. However, possible alternatives include private coinsurance and state coinsurance.

A. Private Coinsurance

In their 1983 reports to Congress on deposit insurance ("Agenda for Reform" and "Deposit Insurance in a Changing Environment"), the FHLBB and the FDIC respectively addressed the prospects of greater private sector involvement in the provision of deposit insurance. Private insurance would likely be used to insure uninsured large deposits that are de facto insured by the government. The de facto insurance would thus be converted to explicit insurance with a corresponding reduction in the federal financial liability due to private sector assumption of some of the risk.

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Private insurers would set their own rates and be able to impose conditions and covenants on institutions. However, certain conditions or safeguards would have to be established for private insurers to protect the federal financial interest. Private insurers would have to meet federally designated qualification standards and would have to be independent of the institution insured.

In the event of a failure handled by payoff, the federal insurer would pay off all depositors, immediately bill the private insurer for its share of the funds payable, and over time, remit to the private insurer its share of the collections. In the event of an assisted takeover or direct assistance, the federal insurer would bill the private insurer for its share of the cost.

Market pricing of even limited private deposit insurance and the monitoring by private insurers of institutions' lending practices and other activities would provide incentives for more prudent risk-taking by depository institutions. More prudent risk-taking, in turn, could lead to reduced costs to the federal insurance funds and a reduction in regulation.

However, because of externalities, such as cyclical changes in capacity and the need to fulfill regulatorily imposed contract conditions, competitively priced private insurance may be more costly than is economically appropriate. Moreover, difficulties may arise in balancing the financial interests of private insurers and federal regulators. Private insurers would probably insist on some role in determining solutions to individual failure cases to protect their financial interest. The discretion and flexibility currently exercised by federal regulators could consequently be diminished. Finally, to the extent that some large depositors are not totally covered by private coinsurance, a degree of instability in the system would be introduced.

B. State Coinsurance: The Unemployment Insurance Model

The deposit insurance system could be restructured to rely far more heavily on a state role using the general model of the unemployment insurance system. The FDIC and the FSLIC would determine each year the size of the insurance fund and the total premium required from each state, based on the recent loss experience in the state. Each state, however, would determine individual bank premiums, subject only to the requirement that total premiums meet or exceed the state's obligation to the funds and a prohibition on discrimination against national banks or thrifts. Any state could choose a flat-rate premium structure, risk-based premiums, or any other method it desired.

This proposal would provide a laboratory in which 50 jurisdictions have an incentive to innovate and develop efficient premium structures. The state coinsurance variant would give states an even greater incentive to consider carefully the effect of their laws and supervisory policies on bank safety and soundness. Delegating the premium structure decision to the states would also permit premium decisions to be more closely tailored to local preferences.

On the other hand, though, to the extent that national uniformity is perceived as a more equitable approach, significant variations in either premium levels or structure between states could result in a less "fair" system. Incentives could develop for certain types of institutions, such as large banks, to locate in some states rather than others. Also, state insurance funds would be more subject to the downturns of a less diversified economy than would a nationwide system. As a result, premiums would need to be higher.

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Question:

In yesterday's New York Times, Lester Thurow argued that our financial markets are so fragile today that we could once again see the financial panics of the 1920's and the great depression of the 1930's.

For example, he said that: "the loan portfolios of American banks include more than $500 billion in farm and third-world debt, where default is easily imagined. As oil prices fall, what were good oil loans are rapidly becoming bad ones. Major banks are sinking under the weight of falling real estate values. Mergers and leveraged buyouts lead to firms that can barely meet interest obligations in boom periods and that could not meet them in a recession."

How fragile do you think the financial system is?

What would you plan to do to alleviate the problems as a member of the Fed?

If you could control both monetary and fiscal policy, what would you do about these problems?

Answer:

The overall financial system has displayed a great deal of strength and resilience throughout the period since World War II. It is questionable in my mind whether it should be referred to at all in terms of "fragility" although in the last analysis the choice of such terminology is quite subjective. Domestically, there are problem situations but the number of institutions while seemingly large in absolute terms is actually a very small proportion of the total. Successive problem situations at large commercial banks, which some commentators felt imperilled the entire system, have been dealt with successfully. Other situations such as that in some parts of the thrift industry and in the agricultural credit system are difficult but give few signs of widening into a situation which would threaten financial stability.

The debt situation of Latin American borrowing nations clearly has links to the financial position of many of our largest banks. That situation is being managed in a cooperative effort with the banking system, the borrowing countries, and the multilateral lending institutions. The Baker Plan promises to incorporate the process and guide it in a promising direction. In an environment of stronger international economic growth and enlarged cooperative action, the situation would appear to be manageable.

As a member of the Board of Governors, I would hope to contribute to the development and extension of current policies which it seems to me are headed in the right direction. A moderate and stable rate of growth in money, healthy economic growth and a gradual transition toward price stability are objectives which the Fed should continue to pursue. In addition, the Fed must never lose sight of its traditional role as a lender of last resort and should stand ready to take decisive action to prevent financial instability from cumulating. The Fed has had a good record in that regard -- with the late 1920's and early 1930's a notable exception -- and that record must and can be extended.

Monetary policy should continue in the pursuit of price stability. Fiscal policy needs to concentrate on narrowing the deficit by reducing what has become a clearly excessive rate of growth in spending. Taxes need to be kept as low as possible -- particularly marginal tax rates -- in order to promote a dynamic and productive private sector.

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Question:

As you well know, the Congressional concern with huge budget deficits resulted in the Gramm-Rudman-Hollings legislation. To meet next year's target deficit of $144 billion, we will probably have to cut about $60 billion. I won't ask you whether we can do that without increasing revenues, because that is a question for us, but what I would like your opinion on is whether it would be better to reduce the deficit by $60 billion, if we had to raise some revenue to do it, or reduce it by some lesser amount -- say, $40 billion -- with only expenditure cuts?

Answer:

In my opinion, whatever budgetary target is agreed upon as necessary and desirable -- whether it be $40 billion, $60 billion or some other amount -- should be achieved by cuts in the rate of growth of federal spending. It is spending which is out of line, amounting recently to about 24 percent of GNP, far above the normal range of recent experience. Receipts, on the other hand, at about 19 percent of GNP are running closely in line with previous experience.

More fundamentally, it is Federal spending which ~~raises~~ claims scarce resources and thereby imposes real costs. Once the spending has been done and the resources have been pulled away from productive use in the private sector, it is a subsidiary issue as to whether the government borrows or taxes. In one case -- borrowing -- the transaction is at least voluntary since no one is compelled to buy the bonds, where in the other case -- taxation -- the payment is not voluntary and reduces the after-tax rate of return on private sector activity.

It is a delusion to believe that raising taxes somehow has beneficial effects on the economy. Quite the contrary, economic growth is inevitably affected adversely. For these and other reasons, the President has properly insisted that expenditure reduction is the necessary way to go about dealing with the budgetary problem. He has consistently viewed taxation only as a last resort after spending has been reduced as far as possible. Tax increases are not a way of solving the budget deficit problem but a way of avoiding the expenditure cuts which are clearly required in the present situation.

Question:

What do you think we should do to strengthen our deposit insurance funds?

Answer:

While I believe both the Federal Deposit Insurance Corporation and the Federal Savings and Loan Corporation (FSLIC) are in reasonably sound condition at this time, I think consideration should be given to ways to bolster the resources, particularly of the FSLIC, should that be necessary over the next few years as the thrift industry recovers from the currently depressed real estate market. Regulators should also address proposals to reduce the number of problem institutions that must be dealt with by the deposit insurance agencies. These proposals relate to such things as depository institution capital adequacy and risk-related deposit insurance premiums.

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ANSWERS TO QUESTIONS SUBMITTED BY SENATOR DIXON

From Manuel H. Johnson

Question:

Do you favor restricting the amounts of preferred stock and mandatory convertible instruments includable in primary bank capital, as proposed by the Board of Governors in November of 1985?

Some small and independently-owned banks have commented that the proposal will eliminate, for them, a principal source of permanent equity and curtail the use of advantageous estate and tax planning tools. Do you believe the proposed regulatory limitations could have such an adverse effect or whether closely held companies could be exempt from its provisions?

Does the proposed limitation on the components of bank capital improve the regulation of capital adequacy which is currently analyzed on a subjective, bank-by-bank basis?

Answer:

The issue of capital adequacy for banking organizations is of great import. I have been supportive of current efforts by the regulators to reexamine both the adequacy of minimum capital requirements as well as the various components of bank capital.

The Federal Reserve Board's proposal, which was issued for public comment, would limit the amounts of preferred stock, mandatory convertible securities, and perpetual debt that could be included as primary capital. The proposal was issued, at least in part, in response to a concern that excessive reliance on these capital instruments might impair an organization's financial flexibility were it to encounter serious or prolonged earnings difficulties.

The concern is an important one, but I have not yet studied the specific proposal. I am interested in learning what the public comments are on this proposal, particularly with respect to possible adverse effects on small banking companies that are closely held.

Finally, while the proposal would establish greater uniformity in the regulation of capital adequacy, I nonetheless believe that examiner judgment in assessing the adequacy of a given institution's capital would continue to play an important role.

Question:

Should this Committee review the entire issue of the "control" of banks, considering issues such as what some argue are in effect cases where there is de facto control by non-voting security holders and holding company creditors?

Answer:

The applicability of the Bank Holding Company Act is based upon a finding that a company has "control" of a bank. For purposes of that Act, a company has control of a bank if --

> (A) the company directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 per centum or more of any class of voting securities of the bank or company;
>
> (B) the company controls in any manner the election of a majority of the directors or trustees of the bank or company; or
>
> (C) the Board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or company.
>
> (3) For the purposes of any proceeding under paragraph (2)(C) of this subsection, there is a presumption that any company which directly or indirectly owns, controls, or has power to vote less than 5 per centum of any class of voting securities of a given bank or company does not have control over that bank or company.

The Federal Reserve Board has issued regulations under this provision of law to explain when, in the Board's view, holding company credit (12 C.F.R. 225.139) or the holding of equity investments (12 C.F.R. 225.143) constitute "control" under the Act. These regulations are both complex and controversial. The question of "de facto control," therefore, may well be an area that merits congressional consideration.

NOTE: Attached are copies of both regulations cited above.

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§ 225.139 Presumption of continued control under section 2(g)(3) of the Bank Holding Company Act.

(a) Section 2(g)(3) of the Bank Holding Company Act (the "Act") establishes a statutory presumption that where certain specified relationships exist between a transferor and transferee of shares, the transferor (if it is a bank holding company, or a company that would be such but for the transfer) continues to own or control indirectly the transferred shares.[1] This presumption arises by operation of law, as of the date of the transfer, without the need for any order or determination by the Board. Operation of the presumption may be terminated only by the issuance of a Board determination, after opportunity for hearing, "that the transferor is not in fact capable of controlling the transferee."[2]

(b) The purpose of section 2(g)(3) is to provide the Board an opportunity to assess the effectiveness of divestitures in certain situations in which there may be a risk that the divestiture will not result in the complete termination of a control relationship. By presuming control to continue as a matter of law, section 2(g)(3) operates to allow the effectiveness of the divestiture to be assessed before the divesting company is permitted to act on the assumption that the divestiture is complete. Thus, for example, if a holding company divests its banking interest under circumstances where the presumption of continued control arises, the divesting company must continue to consider itself bound by the Act until an appropriate order is entered by the Board dispelling the presumption. Section 2(g)(3) does not establish a substantive rule that invalidates transfers to which it applies, and in a great many cases the Board has acted favorably on applications to have the presumption dispelled. It merely provides a procedural opportunity for Board consideration of the effect of such transfers in advance of their being deemed effective. Whether or not the statutory presumption arises, the substantive test for assessing the effectiveness of a divestiture is the same—that is, the Board must be assured that all control relationships between the transferor and the transferred property have been terminated and will not be reestablished.[3]

(c) In the course of administering section 2(g)(3) the Board has had several occasions to consider the scope of that section. In addition, questions have been raised by and with the Board's staff as to coverage of the section. Accordingly, the Board believes it would be useful to set forth the following interpretations of section 2(g)(3):

(1) The terms "transferor" and "transferee," as used in section 2(g)(3), include parents and subsidiaries of each. Thus, for example, where a transferee is indebted to a subsidiary of the transferor, or where a specified interlocking relationship exists between the transferor or transferee and a subsidiary of the other (or between subsidiaries of each), the presumption arises. Similarly, if a parent of the transferee is indebted to a parent of the transferor, the presumption arises. The presumption of continued control also arises where an interlock or debt relationship is retained between the divesting company and the company being divested, since the divested company will be or may be viewed as a "subsidiary" of the transferee or group of transferees.

(2) The terms "officers," "directors," and "trustees," as used in section 2(g)(3), include persons performing functions normally associated with such positions (including general partners in a partnership and limited partners having a right to participate in the management of the affairs of the partnership) as well as persons holding such positions in an advisory or honorary capacity. The presumption arises not only where the transferee or transferred company has an officer, director or trustee "in common with" the transferor, but where the transferee himself holds such a position with the transferor.[4] It should be noted that where a transfer takes the form of a pro-rata distribution, or "spinoff," of shares to a company's shareholders, officers and directors of the transferor company are likely to receive a portion of such shares. The presumption of continued control would, of course, attach to any shares transferred to officers and directors of the divesting company, whether by "spinoff" or outright sale. However, the presumption will be of legal significance—and will thus require an application under section 2(g)(3)—only where the total number of shares subject to the presumption exceeds one of the applicable thresholds in the Act. For example, where officers and directors of a one-bank holding company receive in the aggregate 25 percent or more of the stock of a bank subsidiary being divested by the holding company, the holding company would be presumed to continue to control the "divested" bank. In such a case it would be necessary for the divesting company to demonstrate that it no longer controls either the divested bank or the officer/director transferees. However, if officers and directors were to receive in the aggregate less than 25 percent of the bank's stock (and no other shares were subject to the presumption), section 2(g)(3) would not have the legal effect of presuming continued control of the bank.[5] In the case of a divestiture of nonbank shares, an application under section 2(g)(3) would be required whenever officers and directors of the divesting company received in the aggregate more than 5 percent of the shares of the company being divested.

(3) Although section 2(g)(3) refers to transfers of "shares" it is not, in the Board's view, limited to disposition of corporate stock. General or limited partnership interests, for example, are included within the term "shares." Furthermore, the transfer of all or substantially all of the assets of a company, or the transfer of such a significant volume of assets that the transfer may in effect constitute the disposition of a separate activity of the company, is deemed by the Board to involve a transfer of "shares" of that company.

(4) The term "indebtedness" giving rise to the presumption of continued control under section 2(g)(3) of the Act is not limited to debt incurred in connection with the transfer; ... includes any debt outstanding at the time of transfer from the transferee to the transferor or its subsidiaries. However, the Board believes that not every kind of indebtedness was within the contemplation of the Congress when section 2(g)(3) was adopted. Routine business credit of limited amounts and loans for personal or household purposes are generally not the kinds of indebtedness that, standing alone, support a presumption that the creditor is able to control the debtor. Accordingly, the Board does not regard the presumption of section 2(g)(3) as applica-

[1] The presumption arises where the transferee "is indebted to the transferor, or has one or more officers, directors, trustees, or beneficiaries in common with or subject to control by the transferor."

[2] The Board has delegated to its General Counsel the authority to issue such determinations. 12 CFR 265.2(b)(1).

[3] It should be noted, however, that the Board will require termination of any interlocking management relationships between the divesting company and the transferee or the divested company as a precondition of finding that a divestiture is complete. Similarly, the retention of an economic interest in the divested company that would create an incentive for the divesting company to attempt to influence the management of the divested company will preclude a finding that the divestiture is complete. (See the Board's Order in the matter of "International Bank", 1977 Federal Reserve Bulletin 1108, 1113.)

[4] It has been suggested that the words "in common with" in section 2(g)(3) evidence an intent to make the presumption applicable only where the transferee is a company having an interlock with the transferor. Such an interpretation would, in the Board's view, create an unwarranted gap in the coverage of section 2(g)(3). Furthermore, because the presumption clearly arises where the transferee is an individual who is indebted to the transferor such an interpretation would result in an illogical internal inconsistency in the statute.

[5] Of course, the fact that section 2(g)(3) would not operate to presume continued control would not necessarily mean that control had in fact been terminated if control could be exercised through other means.

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ble to the following categories of credit, provided the extensions of credit are not secured by the transferred property and are made in the ordinary course of business of the transferor (or its subsidiary) that is regularly engaged in the business of extending credit:

(i) Consumer credit extended for personal or household use to an individual transferee; (ii) student loans made for the education of the individual transferee or a spouse or child of the transferee; (iii) a home mortgage loan made to an individual transferee for the purchase of a residence for the individual's personal use and secured by the residence; and (iv) loans made to companies (as defined in section 2(b) of the Act) in an aggregate amount not exceeding ten per cent of the total purchase price (or if not sold, the fair market value) of the transferred property. The amounts and terms of the preceding categories of credit should not differ substantially from similar credit extended in comparable circumstances to others who are not transferees. It should be understood that, while the statutory presumption in situations involving these categories of credit may not apply, the Board is not precluded in any case from examining the facts of a particular transfer and finding that the divestiture of control was ineffective based on the facts of record.

(d) Section 2(g)(3) provides that a Board determination that a transferor is not in fact capable of controlling a transferee shall be made after opportunity for hearing. It has been the Board's routine practice since 1968 to publish notice in the FEDERAL REGISTER of applications filed under section 2(g)(3) and to offer interested parties an opportunity for a hearing. Virtually without exception no comments have been submitted on such applications by parties other than the applicant and, with the exception of one case in which the request was later withdrawn, no hearings have been requested in such cases. Because the Board believes that the hearing provision in section 2(g)(3) was intended as a protection for applicants who are seeking to have the presumption overcome by a Board order, a hearing would not be of use where an application is to be granted. In light of the experience indicating that the publication of FEDERAL REGISTER notice of such applications has not served a useful purpose, the Board has decided to alter its procedures in such cases. In the future, FEDERAL REGISTER notice of section 2(g)(3) applications will be published only in cases in which the Board's General Counsel, acting under delegated authority, has determined not to grant such an application and has referred the matter to the Board for decision.*

(12 U.S.C. 1841, 1844)

(43 FR 6214, Feb. 14, 1978; 43 FR 15147, Apr. 11, 1978; 43 FR 15321, Apr. 12, 1978, as amended at 45 FR 8280, Feb. 7, 1980; 45 FR 11125, Feb. 20, 1980)

§ 225.143 Policy statement on nonvoting equity investments by bank holding companies.

(a) *Introduction.* (1) In recent months, a number of bank holding companies have made substantial equity investments in a bank or bank holding company (the "acquiree") located in states other than the home state of the investing company through acquisition of preferred stock or nonvoting common shares of the acquiree. Because of the evident interest in these types of investments and because they raise substantial questions under the Bank Holding Company Act (the "Act"), the Board believes it is appropriate to provide guidance regarding the consistency of such arrangements with the Act.

(2) This statement sets out the Board's concerns with these investments, the considerations the Board will take into account in determining whether the investments are consistent with the Act, and the general scope of arrangements to be avoided by bank holding companies. The Board recognizes that the complexity of legitimate business arrangements precludes rigid rules designed to cover all situations and that decisions regarding the existence or absence of control in any particular case must take into account the effect of the combination of provisions and covenants in the agreement as a whole and the particular facts and circumstances of each case. Nevertheless, the Board believes that the factors outlined in this statement provide a framework for guiding bank holding companies in complying with the requirements of the Act.

(b) *Statutory and regulatory provisions.* (1) Under section 3(a) of the Act, a bank holding company may not acquire direct or indirect ownership or control of more than 5 per cent of the voting shares of a bank without the Board's prior approval. (12 U.S.C. 1842(a)(3)). In addition, this section of the Act provides that a bank holding company may not, without the Board's prior approval, acquire control of a bank. That is, in the words of the statute, "for any action to be taken that causes a bank to become a subsidiary of a bank holding company." (12 U.S.C. 1842(a)(2)). Under the Act, a bank is a subsidiary of a bank holding company if:

(i) The company directly or indirectly owns, controls, or holds with power to vote 25 per cent or more of the voting shares of the bank;

(ii) The company controls in any manner the election of a majority of the board of directors, of the bank; or

(iii) The Board determines, after notice and opportunity for hearing, that the company has the power, directly or indirectly, to exercise a controlling influence over the management or policies of the bank. (12 U.S.C. 1841(d)).

(2) In intrastate situations, the Board may approve bank holding company acquisitions of additional banking subsidiaries. However, where the acquiree is located outside the home state of the investing bank holding company, section 3(d) of the Act prevents the Board from approving any application that will permit a bank holding company to "acquire, directly or indirectly, any voting shares of, interest in, or all or substantially all of the assets of any additional bank." (12 U.S.C. 1842(d)(1)).

(c) *Review of agreements.* (1) In apparent expectation of statutory changes that might make interstate banking permissible, bank holding companies have sought to make substantial equity investments in other bank holding companies across state lines, but without obtaining more than 5 per cent of the voting shares or control of the acquiree. These investments involve a combination of the following arrangements:

(i) Options on, warrants for, or rights to convert nonvoting shares into substantial blocks of voting securities of the acquiree bank holding company or its subsidiary bank(s);

(ii) Merger or asset acquisition agreements with the out-of-state bank or bank holding company that are to be consummated in the event interstate banking is permitted;

(iii) Provisions that limit or restrict major policies, operations or decisions of the acquiree; and

(iv) Provisions that make acquisition of the acquiree or its subsidiary bank(s) by a third party either impossible or economically impracticable.

The various warrants, options, and rights are not exercisable by the investing bank holding company unless interstate banking is permitted, but may be transferred by the investor either immediately or after the passage of a period of time or upon the occurrence of certain events.

(2) After a careful review of a number of these agreements, the Board believes that investments in nonvoting stock, absent other arrangements, can be consistent with the Act. Some of the agreements reviewed appear consistent with the Act since they are limited to investments of relatively moderate size in nonvoting equity that may become voting equity only if interstate banking is authorized.

(3) However, other agreements reviewed by the Board raise substantial problems of consistency with the control provisions of the Act because the investors, uncertain whether or when interstate banking may be authorized, have evidently sought to assure the soundness of their investments, prevent takeovers by others, and allow for sale of their options, warrants, or rights to a person of the investor's choice in the event a third party obtains control of the acquiree or the in-

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vestor otherwise becomes dissatisfied with its investment. Force the Act precludes the investors from protecting their investments through ownership or use of voting shares or other exercise of control, the investors have substituted contractual agreements for rights normally achieved through voting shares.

(4) For example, various covenants in certain of the agreements seek to assure the continuing soundness of the investment by substantially limiting the discretion of the acquiree's management over major policies and decisions, including restrictions on entering into new banking activities without the investor's approval and requirements for extensive consultations with the investor on financial matters. By their terms, these covenants suggest control by the investing company over the management and policies of the acquiree.

(5) Similarly, certain of the agreements deprive the acquiree bank holding company, by covenant or because of an option, of the right to sell, transfer, or encumber a majority or all of the voting shares of its subsidiary bank(s) with the aim of maintaining the integrity of the investment and preventing takeovers by others. These long term restrictions on voting shares fall within the presumption in the Board's Regulation Y that attributes control of shares to any company that enters into any agreement placing long term restrictions on the rights of a holder of voting securities. (12 CFR 225.2(b)(4)).

(6) Finally, investors wish to reserve the right to sell their options, warrants or rights to a person of their choice to prevent being locked into what may become an unwanted investment. The Board has taken the position that the ability to control the ultimate disposition of voting shares to a person of the investor's choice and to secure the economic benefits therefrom indicates control of the shares under the Act.[1] Moreover, the ability to transfer rights to large blocks of voting shares, even if nonvoting in the hands of the investing company, may result in such a substantial position of leverage over the management of the acquiree as to involve a structure that inevitably results in control prohibited by the Act.

(d) *Provisions that avoid control.* (1) In the context of any particular agreement, provisions of the type described above may be acceptable if combined with other provisions that serve to preclude control. The Board believes that such agreements will not be consistent with the Act unless provisions are included that will preserve management's discretion over the policies and decisions of the acquiree and avoid control of voting shares.

(2) As a first step towards avoiding control, covenants in any agreement should leave management free to conduct banking and permissible nonbanking activities. Another step to avoid control is the right of the acquiree to "call" the equity investment and options or warrants to assure that covenants that may become inhibiting can be avoided by the acquiree. This right makes such investments or agreements more like a loan in which the borrower has a right to escape covenants and avoid the lender's influence by prepaying the loan.

(3) A measure to avoid problems of control arising through the investor's control over the ultimate disposition of rights to substantial amounts of voting shares of the acquiree would be a provision granting the acquiree a right of first refusal before warrants, options or other rights may be sold and requiring a public and dispersed distribution of these rights if the right of first refusal is not exercised.

(4) In this connection, the Board believes that agreements that involve rights to less than 25 percent of the voting shares, with a requirement for a dispersed public distribution in the event of sale, have a much greater prospect of achieving consistency with the Act than agreements involving a greater percentage. This guideline is drawn by analogy from the provision in the Act that ownership of 25 percent or more of the voting securities of a bank constitutes control of the bank.

(5) The Board expects that one effect of this guideline would be to hold down the size of the nonvoting equity investment by the investing company relative to the acquiree's total equity, thus avoiding the potential for control because the investor holds a very large proportion of the acquiree's total equity. Observance of the 25 percent guideline will also make provisions in agreements providing for a right of first refusal or a public and widely dispersed offering of rights to the acquiree [illegible]res more practical and realistic.

(6) Finally, certain arrangements should clearly be avoided regardless of other provisions in the agreement that are designed to avoid control. These are:

(i) Agreements that enable the investing bank holding company (or its designee) to direct in any manner the voting of more than 5 per cent of the voting shares of the acquiree;

(ii) Agreements whereby the investing company has the right to direct the acquiree's use of the proceeds of an equity investment by the investing company to effect certain actions, such as the purchase and redemption of the acquiree's voting shares; and

(iii) The acquisition of more than 5 per cent of the voting shares of the acquiree that "simultaneously" with their acquisition by the investing company become nonvoting shares, remain nonvoting shares while held by the investor, and revert to voting shares when transferred to a third party.

(e) *Review by the Board.* This statement does not constitute the exclusive scope of the Board's concerns, nor are the considerations with respect to control outlined in this statement an exhaustive catalog of permissible or impermissible arrangements. The Board has instructed its staff to review agreements of the kind discussed in this statement and to bring to the Board's attention those that raise problems of consistency with the Act. In this regard, companies are requested to notify the Board of the terms of such proposed merger or asset acquisition agreements or nonvoting equity investments prior to their execution or consummation.

[47 FR 30966, July 16, 1982]

[1] See Board letter dated March 18, 1982, to C. A. Cavendes, Sociedad Financiera.

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